# The VAT Treatment of Merit Goods and Services

National Treasury T16/05

# Disclaimer

This research paper reflects the preliminary views of the National Treasury and not necessarily those of Government. It should be noted that this document is being released in order to facilitate open and frank discussions on the subject of the VAT treatment of merit goods. This will assist Government to formulate well-considered tax proposals which will be informed by the needs of the country and international trends.

# Executive summary

# Executive Summary

## Background to this study

Prior to the introduction of value-added tax (“VAT”) in South Africa in October 1991, a policy decision was taken to introduce a broad-based VAT system, with concessions restricted to a minimum and the needy being assisted as far as possible outside the tax system.

Pressure from various lobby groups and an inability on the part of the Government of the day to prove that the necessary assistance would in fact be given to the needy to compensate for the effect of VAT, resulted in various last-minute concessions being introduced to ensure the smooth introduction of the tax. As a result, the VAT system in operation in South Africa today is more differentiated (and has a narrower base) than was originally intended and the existing concessions have created a precedent for other interest groups to request preferential treatment for goods and service on grounds that the differentiation is merited.

While the claim for concessionary VAT treatment is often based on a desire to address the perceived regressivity of VAT, other arguments are also advanced to justify merit good status. These include:

- The goods or services are in the public interest;
- The goods or services are essential;
- Poorer households should not have to pay VAT on the goods or services;
- Direct targeted budgetary assistance is not capable of ensuring that the goods or services can be supplied to everyone;
- The goods or services are of a cultural nature;
- The goods or services are of an educational nature and taxation thereof would amount to a tax on knowledge; or
- The goods or services can, from a political point of view, not be taxed.

The aim of this study is to determine whether the current VAT concessions should be retained and also to ascertain whether the policy considerations which applied when VAT was introduced are still relevant, or whether changed circumstances would justify the introduction of further concessions for other merit goods and services.

## A framework for the evaluation of changes to VAT

The first chapter provides an *a priori* framework for analysing the likely effects on the economy of any changes to the composition of the tax system. Amongst other things, this framework attempts to establish a set of norms to guide the assessment of changes to the current VAT system. The analysis relies heavily on empirical evidence that supports the theoretical premises of a sound tax framework.

Key conclusions arrived at in this chapter include the following:

- The phenomenon of globalisation is leading to a systematic convergence of tax policies in all of the high-income countries and also a growing number of emerging market economies. This is restricting the leeway that fiscal authorities possess in the design of tax systems.

- Public finance theory suggests that placing the emphasis of income redistribution on the revenue side of the fiscal equation has been replaced by a more pragmatic approach, which attempts to emphasise efficiency, thereby raising the maximum amount of revenues required for addressing equity objectives on the expenditure side of the budget (e.g. through grants and subsidies).

- Any proposed expansion of VAT exemptions or zero-rating would lead to a reduction of fiscal revenues. Although the amendments under investigation are likely to lead to a rather modest reduction of total fiscal revenues, it could be a point of concern during a downward phase of the business cycle.

- An additional consideration is related to the complexity of the VAT system. Further differentiation would run counter to the universal fiscal objective of simplicity, which has become one of the tenets of the South African taxation regime.

- There is a growing volume of empirical evidence suggesting that direct taxes reduce the rate of economic growth whilst indirect taxes do not. Alternatively, is has been shown that the net tax burden (as a result of lower levels of disposable income and saving and sub-optimal resource allocation) imposed on society by indirect taxes tends to be lower than in the case of direct taxes. The option of increasing personal income tax (PIT) as a means of augmenting the revenues forfeited by an expansion of the range of VAT concessions is therefore not regarded as appropriate. Also, any increase in PIT would serve to reduce an individual income earner's ability for future consumption, which has to be financed out of current savings and pensions.

- The chapter concludes with a time-series analysis of trends relating to the composition of fiscal revenues that suggests limited leeway for any future increases in the relative shares of company tax, wealth taxes, and selective consumption-based taxes.

## International trends in the VAT treatment of merit goods and services

Chapter 2 of the study extends the analysis into a more detailed overview of international trends with regard to VAT relief measures or concessions. It is pointed out that VAT concessions will normally only tend to reduce the regressive nature of the VAT system in the event of the expenditure patterns of the poor being viewed in isolation. In this regard, a zero-rating would normally be the most effective form of concession. The relative effectiveness of an exemption or lower VAT rate would depend on the pricing structure of a particular industry.

VAT concessions which cannot be targeted to apply only to the poor and needy, will distort equity in the economy, as the affluent will also benefit from such concessions, thus worsening the inherent regressive nature of the VAT system, whilst also exerting a negative impact on revenue collections. Any VAT concessions aimed at benefiting the poor will, unfortunately, exert a negative effect on the other policy considerations of neutrality, efficiency and simplicity. Further, a concession will normally distort consumer and producer choices and preferences, often resulting in a snowball-effect of subsequent requests for concessions (to counter the effect of the original concession).

Global VAT experience indicates that both high-income countries and developing countries provide some form of relief for merit goods or services, especially medical services and medicines, while relief is also often given in respect of books, newspapers and journals. It should be borne in mind, however, that the VAT rates in most of these countries are higher than in South Africa.

## Policy considerations when VAT was first introduced in South Africa

The policy considerations that applied when VAT was introduced in South Africa during 1991 are examined in Chapter 3. An understanding of the motivation for, and philosophy surrounding, the current treatment of the merit goods or services under consideration is essential to determine whether changed circumstances and times justify (or necessitate) VAT reform regarding the VAT treatment of these goods or services.

The policy decision was to introduce a broad-based VAT system, The intention was to restrict concessions to the minimum and the needy would be assisted as far as possible outside the tax system.

However, due to pressure from various sources and assistance could not be given immediately to the needy to compensate the effect of VAT, various concessions had to be introduced.

## The views of stakeholders

Chapter 4 of the study addresses the methodology and results of a process of determining the views of stakeholders from the industries identified in the list of merit goods. The responses received to a questionnaire distributed to the identified stakeholders were duly analysed. Those stakeholders requesting a favourable VAT dispensation did not consider any option other than zero-rating and believed that any costs associated with a change from the current dispensation would be minimal, provided that the change was towards zero-rating. This suggests that there is recognition of the fact that exemption is cumbersome and costly to administer.

Stakeholders advocating concessionary VAT treatment for medicines and books did provide plausible and practical suggestions for the definition of the products that would be accorded the favourable status, but elements of discrimination are present in these definitions.

It is also possible that the requests for merit good status, and the definitions proposed, would achieve a secondary objective of providing barriers to entry or other competitive advantages for their proponents. In the case of medicines, the proposed limitation of any concession to registered medicines could serve to reduce competition from unregistered medicines, while in the case of books limiting preferential treatment to printed books with ISBNs would afford some advantage over digital material.

While international precedent exists for concessionary VAT treatment of all the existing and proposed merit goods and services, there appears to be relatively little in the way of new arguments to support the claim of merit good status from those that were considered by the tax authorities and taxation experts when VAT was first introduced in South Africa. At the same time, while none of the submissions received addressed the complete range of issues contained in the questionnaire, there was nothing in the arguments that they contained that would lead to their automatic exclusion from further consideration.

## An economic evaluation of existing and proposed VAT concessions

The purpose of the empirical analysis contained in Chapter 5 is to assess the economic consequences of both existing and proposed exceptions, specifically whether such changes would achieve their stated objectives. The analysis indicates quite clearly that with the exception of maize-meal, bread flour and maize rice, the existing zero-ratings and exemptions do very little to address the perceived regressive nature of the VAT system. In fact they serve to make the VAT system more regressive by transferring substantially more benefits from preferential product treatment to higher income groups than those that flow to lower income groups. The adoption of a more favourable VAT dispensation in respect of any of the proposed new merit goods and services would similarly not serve to offset any regression inherent in VAT. This tends to support the view contained in Chapter 2 that VAT concessions will only serve to reduce the regressive nature of VAT if the spending patterns of the lower income groups are viewed in isolation. As soon as account is taken of the spending of higher income groups, then measures such as zero-rating, exemption and the adoption of lower VAT rates actually tend to exacerbate the regression of the VAT system.

These results call into question the relatively widespread use of zero-rating and exemption in relation to basic foodstuffs and other items, and suggest that there should be more effective methods of assisting the poor through fiscal expenditures and transfers. An analysis of the economic incidence of VAT in respect of some currently zero-rated products indicates that suppliers of both maize meal and fresh milk benefit to a greater extent from the zero-rating than consumers. By contrast, the bulk of the benefits arising from the VAT zero-ratings on rice and brown bread currently accrue to consumers.

The analysis was then extended to take account of the economic incidence of VAT on products that have been proposed as warranting merit good status. In the case of both prescription and non-prescription medicines, the VAT incidence is currently estimated to be shared between suppliers and consumers in the ratio of around 60% to 40% respectively. This means that consumers would probably only enjoy 40% or less of any savings arising from changes to the existing VAT dispensation. In the case of books, the VAT incidence currently falls predominantly on the suppliers of books, which means that if VAT were to be removed, consumers would probably receive substantially less than the full portion of any facilitated reduction in price.

It does appear that rising average real income levels have a more significant role to play in facilitating increased consumption of meritorious products than changes to their VAT treatment. A system of VAT that embodies the lowest possible excess burden, and which is the most efficient in generating revenue to fund social and redistributive expenditures will therefore tend to support higher levels of income growth over time.

The extension of the analysis to market behavioural trends – as indicated by pricing behaviour over time – does not suggest that the existing VAT dispensation has facilitated profiteering on the part of suppliers. However, the fact that most of the products zero-rated under VAT were exempt under GST might mean that the benefits of such preferential treatment for consumers were eroded before VAT was introduced.

## The fiscal impact of existing and proposed VAT concessions

The analysis contained in Chapter 6 essentially aims to quantify the impact of VAT differentiation on the country's tax base. If the empirical analysis of the fiscal impact of existing and/or proposed zero-ratings and exemptions is limited to the 2006 value of the VAT portion of total household consumption spending on a particular product, then the direct fiscal impact is quite marked. Depending on the weight of the product in the household basket, the putative "losses" to the fiscus could range from almost R2 billion in the case of maize meal and electricity, to as little as R1.9 million for a product such as bananas.

However, the actual loss to the fiscus would be substantially more muted than these figures suggest because any "savings" arising from preferential VAT treatment would generate income and substitution effects. It is likely that the actual loss to the fiscus would approximate the share of the difference between potential VAT collections if there were no concessions and leakages and actual collections of the initial or direct VAT loss referred to above. Currently, this would amount to a final, economy-wide loss of around 18% of the VAT portion of current spending, which translates into final fiscal losses associated with the zero-rating of books of about R16 million per annum. On the other hand, these figures also mean that the additional VAT that would be generated because of the standard rating of a product that is currently zero-rated would also be similarly muted.

As a result of the diluted fiscal impact, the adjustments required to either the standard VAT rate, or other forms of tax to offset losses arising from additional zero-ratings, or gains from the removal of existing VAT concessions, would be quite limited. For example, the zero-rating of electricity would necessitate an increase of around 0.24% in the VAT base (which translates into an increase of the current VAT rate of 0.03 percentage points, i.e. to 14.03%).

The arguments against the introduction of additional VAT exceptions to accommodate merit goods and services on the basis of fiscal affordability would therefore tend to be relatively weak in relation to individual products. The costs to the fiscus would, however, become more pronounced if whole categories of products (such as medicines) were given favourable treatment.

## The impact of VAT policy changes

A policy impact assessment is undertaken in Chapter 7. The anticipated impact of the introduction of concessions for merit goods on the relevant policy considerations is analysed. The purpose is to ascertain whether the policy considerations which applied when VAT was introduced still apply in the context of the current economic and fiscal environment.

A number of examples are provided that clearly illustrate the potential for regressivity to worsen by allowing a blanket concession for basic or essential goods or services, due to the fact that the distributional consequences of concessions could favour the higher income households relative more, with only limited benefits for the low income earners.

The analysis concludes that it is difficult to eliminate or even alleviate the perceived regressiveness in the VAT system by way of concessions, whether these take the form of zero-rating, exemptions or lower rates. It is suggested that distributional issues are better served by income taxation and by carefully targeted payments or social assistance to households affected by a particular tax.

## An evaluation of the administrative implications of proposed VAT concessions

Chapter 8 contains an administrative impact assessment. Internationally, the administrative and compliance cost of VAT is regarded as one of the main disadvantages of a VAT system. It is accepted that administrative and compliance cost can be prevented or reduced by limiting the number of concessions. The merits of these concerns and arguments are examined in the context of the current technological and administrative position in South Africa.

It is pointed out that a lack of accurate data makes it difficult to quantify general VAT compliance costs or the anticipated compliance cost of further concessions. The latter is nevertheless analysed in terms of the following key issues: problems of definition; requirements and procedures; system changes (i.e. the need to the implement computer, bookkeeping and financial system changes); and control and enforcement.

Reference is made to authoritative studies that have quantified, to some extent, the administrative impact of VAT concessions on all the relevant role-players.

The Katz Commission concluded that adaptation to the VAT system was undesirable on revenue grounds, would have considerable administrative and compliance cost implications, and could not be assured to provide relief in practice to the most vulnerable groups who most need support

Furthermore, VAT may trigger new compliance costs for businesses which should not be underrated. Compliance costs include not only human and information technology costs for producing VAT documentation, but also the costs associated with preparing VAT accounts or reports and preparing and filing VAT returns. Unclear or outdated legislation and a lack of guidance from the tax authorities leads to uncertainty, thereby increasing compliance costs and risk. Errors regarding the application of VAT rules can trigger penalties and other costs for businesses and their directors, particularly small businesses.

The chapter concludes that the problems of defining the scope of further VAT concessions, drafting the amendments to the VAT Act and regulating the procedural and documentary requirements for applying a new zero-rating, exemption or lower VAT rate could be significant to SARS.

# Recommendations

As a result of the analysis summarised above, the study team has developed the following recommendations, which are included here in their entirety to avoid possible misunderstandings.

## Ideal VAT system

In spite of the fairly widespread use of exceptions internationally, the results of this study tend to confirm the view of the IMF that a VAT system with the smallest possible number of exemptions, zero-ratings and lower rates is desirable. In this context, efficiency and simplicity considerations should dominate, and equity and other social objectives should be pursued through the expenditure side of fiscal policy.

### *Addressing regressivity with exceptions*

The perception that VAT is inherently regressive is one of the primary motives behind calls for concessionary treatment. While it is true that the VAT paid by lower income households may represent a higher proportion of their disposable income in a given period, this arises because higher income households tend to save greater portions of their income. However, these savings are used in subsequent periods (during retirement for example) to finance current expenditure, at which stage they will attract VAT. The proportion of disposable income paid in VAT by different income groups over their respective lifetimes will therefore tend to converge and will probably not be markedly different.

In this context, there is substantial empirical evidence to indicate that existing zero-ratings and exemptions do little to reduce the perceived regressivity of the VAT system. In fact, in almost all cases, they serve to make the system more regressive by conferring substantially more benefits on higher income groups than on lower income groups. Unless ways can be found to target exceptions so that they are enjoyed only, or at least predominantly, by low income households, then the adoption or perpetuation of a favourable VAT dispensation should not be used as an instrument to counter regressivity.

### *Existing zero-ratings*

A strong economic case can be made for the removal of existing zero-ratings on all products (other than exports) with the possible exception of maize meal and mealie rice. However, the potential political backlash against such a step should not be underestimated. For this reason any attempt to remove existing zero-ratings should be directly, and explicitly, linked with the adoption of direct fiscal measures to offset the impact of increased VAT charges on lower income households.

Two approaches could be considered. Either sub-categories of currently zero-rated products could be standard rated in a phased manner, with offsetting explicitly-linked increases in social pensions and other transfer payments (including the possible introduction of food stamps). The phasing could begin with product categories where the relative benefit enjoyed by higher income groups is the greatest – such as cooking oils with a gradual move to products where the relative benefits of zero-rating are more equally shared between higher and lower income households. The potential problem with this approach is that it would take a long time to implement, and the current means available to the authorities of reaching all low income households are quite limited.

Secondly, a "big bang" approach could be followed where all existing zero-ratings are scrapped (with the possible exception of maize meal and mealie rice) and simultaneously, a mechanism to channel income to all lower income households, such as significantly enhanced social grants, was introduced. This system of social grants or food support would, necessarily, need to have a broader reach than the existing social grant system – so that tangible and effective assistance was provided to all low income households. Such an approach would be easier to sell politically, and the trade-offs would be easier to calculate. It would, however, be imperative that the two initiatives were well synchronised and that the systems needed to administer such transfers were in place.

### *Existing exemptions*

Exemptions currently confer limited benefits and impose measurably larger compliance costs on the affected vendors, particularly where such vendors are engaged in mixed supply. They also tend to increase the regressivity of the VAT system because the bulk of benefits flow to higher income households. Consistent with the proposal to eliminate existing zero-ratings outlined above, exemptions should also be withdrawn except in cases where the goods or services are "hard-to-tax", (e.g. financial services, commuter transport by taxis).

Failing this, consideration should be given to replacing current exemptions with a lower rate of VAT, which should be set at a level that ensures that vendors are not subsidised, but which succeeds in eliminating VAT from input costs. In the case of the products studied, this would require the products to be levied with VAT of between 7% and 8% at the final point-of-sale, while at the same time allowing vendors to claim back input credits. Such a system is predicated on the assumption that roughly half of the total value added of these products occurs at the final stage of the supply chain. It would have the advantage of substantially simplifying administration as it would remove the need to apportion costs between standard rated and exempt supplies.

### *Proposed additional merit goods and services*

Although there are international precedents for affording all of the proposed additional merit goods and services a preferential VAT dispensation, such an approach is not supported.

Apart from the fact that the adoption of a favourable VAT dispensation in the case of proposed merit goods and services would be inconsistent with the broad approach outlined above, the specific products considered would not, by virtue of a different VAT treatment, assist in reducing regressivity. Nor is it likely, in the case of books, that consumers would enjoy a substantial reduction in prices as a result of the zero-rating of the product. In any case, we are persuaded by the view that the problem of relatively low book penetration in South Africa has its origins primarily in low levels of literacy and generally poor reading skills. This problem would be more effectively addressed by the provision of a variety of reading books in all official languages to all levels of primary and secondary schools in South Africa with priority being given to the first three years of formal schooling (grades 1 to 3). This will require substantial additional funding for the education sector, but would also provide significant benefits to the local printing and publishing industry.

The analysis of both prescription and non-prescription medicines indicates that the VAT incidence is currently shared between the supply chain and consumers in the ratio of 60% to 40%. This implies that consumers are likely to enjoy 40% or less of any “savings” facilitated by the adoption of a more favourable VAT dispensation. One of the problems with the market for medicines appears to be that there is limited and a-typical sensitivity by consumers to pricing in both the public and the private health care systems. This results in consumers either being indifferent to the price of medicines (in the public healthcare system), or actively favouring higher-priced medicines as a means of obtaining better “value for money” from medical schemes. Incentive structures for medical practitioners may serve to exacerbate the problem.

While acknowledging that the market for medicines is complex and deserving of additional study, the research team does not believe that these complexities strengthen the argument for a different VAT treatment to the status quo.

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# Background to the study

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VAT was introduced in South Africa with effect from 30 September 1991. The Government of the day announced during 1988 that it intended transforming the existing general sales tax ("GST") system to a value-added tax ("VAT" system.[1] Some of the main reasons advanced for the implementation of a VAT system were the problems related to the recovery and evasion of sales tax and the extent of the erosion of the sales tax base due to food exemptions.[2]

In line with recommendations by the International Monetary Fund ("IMF") and based on the global experience of VAT, the Government decided to introduce a broad-based VAT with minimal exceptions and concessions. However, this purist VAT goal often had to make way for well-motivated requests for special treatment. The decision to make an exception is normally motivated by a combination of various considerations, namely an attempt to address social policy, fairness, economic neutrality and / or political objectives, or merely to ease the burden of administration.

The existence of such exceptions however provides a precedent for various stakeholders, interested parties and lobby groups to request further exceptions. In South Africa, the National Treasury and the South African Revenue Service ("SARS") have been approached on a regular basis to exempt or zero rate goods or services that are standard rated under the current VAT dispensation.

National Treasury accordingly requested a consultancy to assist with the review of past exceptions and the consideration of possible new ones in respect of merit goods and services. The key objectives of this study are to –

- develop a sound tax policy position with regard to the VAT treatment of merit goods and services in general;
- review whether existing merit goods or services treated as exceptions are in line with sound tax policy principles;
- develop a sound tax policy position with regards to the VAT treatment of books, medicines, medical services and municipal services (electricity and water);
- analyse the appropriateness and effectiveness of the existing and proposed VAT relief measures and the distributional implications of the suggested merit goods or services; and

[1] White Paper on The Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa (The Margo Report. (1988*).*
[2] *Supra* 335.

- ensure protection of the tax base but at the same time ensuring that the VAT system is equitable acceptable, and administratively not too complex.

Between the publication of a Draft Value-Added Tax Bill in June 1990 and the introduction of VAT in September 1991, a fairly extensive consultative and communication process was undertaken under the auspices of Value Added Tax Committee (“VATCOM”), a committee appointed by the Minister of Finance with members drawn from both the private and public sectors. VATCOM received almost 1 100 written submissions and heard verbal evidence from 57 institutions and individuals. A number of these submissions included requests for some form of preferential VAT treatment on the basis that the good or service concerned was in some way different, or had unique characteristics that merited a favourable dispensation.

In its report published in February 1991, VATCOM ultimately recommended that the type of VAT system introduced should:

- Keep exemptions, zero-ratings and exceptions as a rule to an absolute minimum to simplify the system and to minimise the opportunity for evasion.
- Make every effort to simplify the administration of the system to reduce the compliance costs of vendors and, in particular, small vendors.
- Where the Government is of the opinion that assistance must be granted to any group of persons or for the use of any goods or services, this should preferably be done outside of the tax system.

Each of the requests for preferential treatment were assessed and in most cases rejected on the basis that, however meritorious the product, a different VAT treatment would be contrary to the broad approach outlined above. In the case of basic foodstuffs, VATCOM recommended that the Minister of Finance provide relief by either zero-rating a limited number of products (maize products, rice, bread and milk powder were specifically identified) that were exempted from the previous GST regime or by providing direct budgetary assistance to the needy to compensate them for any additional costs associated with the introduction of VAT.

Since many of the requests for preferential treatment received by the tax authorities and National Treasury since the introduction of VAT relate to products that were also considered by VATCOM, the questions that this study seeks to investigate are, amongst others:

- Whether international experience warrants a change in the fundamental view of VAT as a broad-based consumption tax with minimal exceptions, and how exceptions are dealt with in other countries. This issue is addressed in greater detail in Chapter 2.

- The policy considerations that were applied in South Africa when VAT was introduced. These also provide an essential background for the current study and are set out in Chapter 3.
- Whether the arguments advanced by the stakeholders advocating a favourable treatment for a particular good or service have changed significantly over time, or whether new products meriting special treatment have been identified. The results of this consultation process is summarised in Chapter 4.
- Whether the social and/or economic conditions prevailing in South Africa have changed so substantially as to warrant a different VAT treatment for the identified merit goods and services, and what the implications of such different treatment might be. This is covered in Chapter 5.
- What the impact of any changes to the VAT treatment of merit goods and services might be to the fiscus. This is addressed in Chapter 6.
- What the anticipated impact of the introduction of any further VAT concessions would be on VAT policy considerations. This is analysed in Chapter 7.
- Whether changes in administrative and other system technologies have advanced to an extent that the compliance cost constraint that might previously have mitigated against the different treatment of certain goods makes changes in the VAT treatment of merit goods and services more feasible. This is addressed in Chapter 8.

Chapter 1 of the study commences with a framework for the analysis of VAT and contrasts changes in the composition of tax revenues globally with those in South Africa.

The recommendations are addressed in Chapter 9.

# Chapter 1: A framework for the analysis of VAT

# Introduction

One of the key research requirements stated in the Terms of Reference for this study is an investigation of VAT relief measures (also referred to in the Terms of Reference as VAT exceptions). The purpose of this section is to provide an *a priori* framework for the analysis of the effect of full or partial exemptions from VAT. The framework developed below establishes a set of norms to guide the assessment of changes to the current VAT system.

The chapter begins with a concise statement of the principles of a sound taxation system. The more detailed normative framework will essentially be based on these principles and will extend the analysis in the following areas:

- Direct changes to the fiscal revenue stream;
- Short term economic incidence, which will utilise the concepts of price elasticity of demand and supply to distinguish between the effect on consumers and producers;
- Longer-term economic incidence, which will examine the relevance to further VAT differentiation of the concept of income elasticity of demand; as well as certain indirect effects flowing from changes to relative prices; and
- Efficiency considerations, including the concept of excess burden and changes to returns on investment related to shifts in demand and supply between different markets.

This normative framework will be followed by an overview of relevant empirical analysis and data sets, in order to quantify the hypothetical merits and demerits associated with a degree of selectivity/differentiation in the VAT system.

Finally, this section includes a fiscal revenue analysis that examines trends in the composition and growth of the tax system and composition of taxes in South Africa. The analysis is augmented by a section that also compares changes to the structure of taxation of South Africa with that of countries belonging to the Organisation for Economic Cooperation and Development (OECD). The latter represents the majority of South Africa's key trading partners.

# The principles of taxation

Two broad principles of taxation have evolved with the trend for governments in high-income countries to command a relatively high share of the total expenditure on gross domestic product ("GDP"), namely the principles of equity and efficiency. The following concise overview draws on the work, *inter alia,* of Rosen (1995)[3], Hicks (1948)[4] and Buchanan & Flowers (1987).[5]

## Equity

The principle of equity relates to the fairness of taxation and represents a topic that has remained high on the agenda for public debate for more than a century. Until the middle of the 20th century, supporters of the concept of maximising economic freedom in society remained sympathetic to John Stuart Mill's argument against tax progression. Beyond an exemption of a minimum subsistence level, Mill argued that a progressive income tax acts to impose a penalty on people for having worked harder and saved more than others. His injunction to tax progression was formulated as follows: "A just and wise legislature("s) … impartiality between competitors would consist in endeavouring to see that all should start fair, and not in hanging a weight on the swift to diminish the distance between them and the slow"[6].

In a society without a large degree of income equality, the principle of equity would, in fact, be best served by proportionality in taxes. In practice, however, economic inequalities do exist in virtually all societies, and the requirement of fairness is therefore pursued. It is usually based on the following two tenets:

- Ability to pay, in terms of which the tax burden of the individuals should be positively correlated to his or her command over income and wealth. This remains a highly subjective issue due to differences of opinion over the definitions of revenue, wealth and also the degree of progression that should be implemented.

- Benefit received, which implies that people who benefit from particular government services should also bear the corresponding tax burden.

It stands to reason that a significant degree of income tax progression will remain part and parcel of the taxation system in a country like South Africa, where levels of income inequality, is high and also quite visible, (e.g. existence of informal settlements close to affluent neighbourhoods). In a global economy, however, highly skilled professionals are becoming increasingly mobile and this phenomenon limits the leeway that governments possess in designing tax policies.

A significant degree of international convergence continues to take place with regard to the fundamental components of macroeconomic policy, a trend that is manifesting itself in marginal to modest differences in the tax rates, inflation rates, import duties and interest rates between most high-income countries and several of the stable emerging market economies. In this context, it would not be economically viable for a

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[3] Rosen, H, 1995: *Public finance,* Chicago: Irwin.
[4] Hicks, U K, 1948: *Public finance,* Cambridge: Cambridge University Press.
[5] Buchanan, J M and Flowers, M R, 1987: *The public finances*, Illinois: Richard D Irwin.
[6] Mill, J S, 1985: *Principles of political economy,* Middlesex: Penguin Classics (first published in 1848).

small, open economy like South Africa to place the entire responsibility of income redistribution on the revenue side of the fiscal process. A more pragmatic approach (which is, by and large, being followed by the South African government) would be to ensure that the tax system is as efficient as possible in raising the revenues that are required for allocation to a large variety of expenditure programmes that benefit the poor.

## Efficiency

Taxation serves to reduce disposable income (for individuals) and profits (for businesses). Lower incomes translate into lower demand, with a lagged ripple effect into lower output and increased unemployment. Lower company profits exert a dualistic negative effect on the economy. First, it means a reduction in dividend payments, which has the same effect as sketched above (to the extent that individuals receive the dividends). Secondly, undistributed profit levels decline, which reduces the ability of the private sector to invest in new productive capacity. Although the negative effects on growth need to be juxtaposed with positive effects emanating from the expenditure side of the fiscal equation, these arguments constitute an endorsement of the need to pursue efficiency considerations in the formulation of a tax system.

Fiscal authorities are today guided by the following principles that underpin this important objective:

- <u>Simplicity</u>. This requirement entails that the tax system should not be difficult to understand and that the costs involved with the administrative compliance by individuals and businesses be kept as low as possible.

- <u>Low administration costs</u>. The collection of taxes entails a cost to the fiscus (and, ultimately, to the taxpayer), that is not related to any public service embodying an element of value added to the economy. A government should, therefore, ensure that the system of national revenue collection is administered in such a way as to keep collection costs as low as possible.

- <u>Matching of tax impact and incidence</u>. In the event of the imposition of selective commodity taxation, the fiscal authorities need to ensure that their objectives with regard to the tax impact (the so-called statutory tax incidence) are not thwarted by substantial differences in the economic incidence of the taxes. In order to ensure that no mismatch occurs between tax impact and tax incidence, it is necessary to be aware of the elasticities of supply and demand of the particular commodities. As a general rule, a high degree of tax shifting will occur when the elasticity of demand is low and the elasticity of supply is high.

- Diversity of the tax base. The existence of a variety of tax sources protects a government from the negative impact of an unexpected decline in revenue from any one particular source of taxation. A relatively broad tax base also has the advantage of being able to keep marginal tax rates as low as possible.

- Flexibility. In essence, the principle of flexibility maintains that tax rates and sources should be subject to regular policy amendments in order to meet changing economic conditions. An example would be to lower personal income tax rates during a recession, thereby allowing for discretionary anti-cyclical fiscal policy. This principle is not applied in practice to the extent that some economists would recommend.

- Moderate rates of progression. It has been pointed out that an overdue emphasis on progressive income tax has the twin dangers of eroding the productivity of an economy and of shrinking the tax base. This is particularly true when marginal rates are relatively high and the tax ceiling is relatively low (by international standards). The existence of an exemption level for low-income earners automatically introduces an element of tax progression. Attempts to effect a more rapid progression of the average tax rate may eventually yield an inferior amount of revenue than a more moderate rate of progression over the medium to long term.

- Minimising excess burden. This principle is not as prone to subjectivity as those related to flexibility and the redistributive aspects of taxation. Consensus should exist with regard to minimising the costs associated with the distortions induced by various taxes, particularly those that are levied on commodities. To keep the excess burden of commodity taxes at a minimum, the marginal excess burden of the last unit of revenue raised from each commodity must be the same. To satisfy this requirement, the inverse elasticity rule has been developed by Frank Ramsey (1927)[7], which states that, as long as goods are unrelated in consumption, tax rates should be inversely proportional to elasticities. The logic behind this rule is related to the fact that excess burden is a consequence of distortions in quantities demanded. To minimise this burden, tax rates should be differentiated in such a way that changes are in the same proportion. Efficient commodity taxation therefore requires that relatively high rates of taxation be applied to goods with a relatively inelastic demand, and vice versa.

- Maximising revenue. A recent development in the theory of taxation is to take cognisance of the fact that tax revenues determine the fiscal affordability of expenditure programmes, which invariably also attempt to pursue equity objectives. It stands to reason that a tax system that attempts to maximise the amount of revenue that can be collected will enhance a government's ability

[7] Ramsey, F, 1927: "A contribution to the theory of taxation", in *Economic Journal no 37.*

to address the issue of equity through a variety of expenditure programmes. In South Africa, this has become prevalent in the format of welfare grants, community development and the large-scale subsidisation of housing, education, health services, electricity consumption and water consumption, as depicted by Table 1.

**Table 1: Average annual real growth in government expenditure 1994 to 2006**

| Average annual real growth in government expenditure 1994 to 2006 | |
|---|---|
| **Functional Area** | **%** |
| Welfare | 11.4 |
| Prisons | 7.9 |
| Housing & community services | 6.6 |
| Police | 4.9 |
| Health | 4.8 |
| **Total** | **4.5** |
| Transport | 3.6 |
| Education | 3.6 |
| Defence | 1.7 |
| Agriculture | 1.3 |
| Interest | 1.2 |

*Sources: National Treasury; Botha*[8]

## Tax revenue effect

The essential rationale for the imposition of taxes on society is the need for government to finance public expenditure. The latter is necessary mainly to augment the shortcomings of the market system. Theoretically, a competitive market economy generates a Pareto efficient allocation of resources that does not leave scope for any government involvement. For many products and services, however, the conditions for competitive markets are absent.

It is also fairly obvious in modern societies that efficient resource allocation is not necessarily socially desirable. A variety of reasons therefore exist for government intervention in the economy, without which the welfare of society would have been significantly lower, either in economic terms or in terms of socio-political instability. These include national defence, public works, education, health and the maintenance of law and order.

[8] Republic of South Africa, National Treasury, 2007: *Budget Review 2007*, and Botha, R F, 2007: "Budget heralds new era of welfare policy", in *Big Picture*, February 2007 (internal publication of PricewaterhouseCoopers, SA).

The first and foremost effect of the raising of fiscal revenues via taxation is to impose a cost on taxpayers through a reduction in their disposable incomes. It is important at the outset to clarify the misconception that businesses bear a portion of the burden of taxation. Businesses are ultimately owned by individuals. Even the investment of a pension fund in a particular company represents the collective assets of all the members of the fund. Only people can therefore bear the burden of taxes. Exactly how the burden of the VAT is borne by members of society will be discussed in the following sub-sections. For the purposes of this study, the empirical analysis of the effect of VAT will be conducted from the perspective of a decline in revenue (ensuing from the assumption that certain goods and services will be exempted from the tax).

It stands to reason that any expansion of the range of goods and services that are exempt from VAT will lead to a loss of government revenue.

## Statutory incidence

Statutory incidence refers to the legal responsibility for paying the tax. Since VAT has the same effect on the final price paid for goods and services as a GST, is may be classified as a broad-based consumption tax. For the purposes of this study, the analysis will be based on commodity taxation. Furthermore, the incidence analysis will be based on negative incidence, i.e. the positive effects on consumers and producers that ensue as a result of the removal of existing VAT on a particular product. Exempting a particular product from VAT has the statutory implication of reducing the taxation burden of the group of consumers that purchase the particular product.

The larger the weight of this commodity in a person’s basket of consumption goods, the more pronounced will be the reduced taxation burden (under the assumption that the full benefit of exemption is passed on to the consumer in the form of lower prices). The latter condition will hold in the case of a constant-cost competitive industry.

## Economic incidence (short term)

For a large variety of commodities, costs are not constant, which means that supply curves are upward-sloping. In such cases, the price elasticities of demand and supply will determine the extent to which a reduction in price (resulting from VAT exemption) will benefit consumers and producers.

In the short term, the result of exempting a product from VAT will be manifested in a lower price. It follows that for a normal downward-sloping demand curve, the lower price will result in an increase in the quantity demanded.

The reason why policymakers should have a sound understanding of the role of price elasticities of demand and supply is related to the divergent effects of policies that affect prices. Depending on the price elasticities, a reduction in price could either lead to an increase in the total expenditure on a particular product or to a decline in such expenditure.

In the case of exempting a product from VAT, the effect will be the same as the removal of any *ad valorem* commodity tax, namely a proportional downward shift of the particular supply curve, with the vertical intercept remaining constant. In the case of most products, supply curves are positively-sloped, whilst demand curves are negatively-sloped. In such cases, VAT exemption will lower the price paid by consumers and increase the price received by producers (compared to a situation where VAT is levied).

## General rules

The following general rules serve to guide any quantification of negative VAT incidence:

- The more elastic the demand curve, the more the lower price will benefit producers (and vice versa); or
- The more elastic the supply curve, the more the lower price will benefit consumers (and vice versa).

## Substitutes

Market demand curves vary substantially from one product to another with regard to the sensitivity of changes in the quantity demanded to changes in price. If a large variety of close substitutes exist for a particular commodity, its price elasticity of demand is likely to be quite high and any price changes will induce significant changes in the quantity demanded. The impact of substitutes will be affected by the scope of definition of a particular product. For example, one brand of headache pills will tend to exhibit a larger price elasticity of demand than all headache pills.

## Relative weighting in commodity basket

In general, goods that do not constitute a significant financial outlay within a consumer’s total commodity basket will tend to possess relatively low price elasticities of demand and vice versa. The logic behind this rule is related to the improbability of a 20% increase in the price of a product like salt leading to a significant decrease in its consumption. On the other hand, a 20% increase in the price of beef should induce many consumers into purchasing less beef and more products such as mutton, fish, poultry and other key sources of protein.

## Time interval

Most goods exhibit higher price elasticities of demand over longer time intervals. This phenomenon is related to the higher probability of finding substitutes over the longer term than the shorter term. A case in point is the reaction of the industrialised nations to the increase of more than 160% in the oil price between the beginning of 1979 and April 1980. Initially, the quantity demanded did not change much, but in ensuing years many countries invested large amounts of money in the development of alternative energy sources. The increase in substitutes for oil-driven energy contributed heavily to the subsequent reduction in the real price of oil by 65% between 1980 and 1990[9].

# Economic incidence (longer-term)

## Impact on interrelated markets

Studies of the economic incidence of taxation in the short term are usually based on a partial equilibrium analysis (as will be the case with much of the quantitative assessment that follows in Chapter 5).

General equilibrium models are useful for extending this analysis beyond only one market at a time and are essentially focused on a longer-term view. General equilibrium analysis takes into account the ways in which different markets are interrelated.

Harberger[10] has developed a model that can be utilised for the interpretation of the effect of a reduction in the rate of VAT. The assumptions of the model are as follows:

- Constant returns to scale of capital and labour
- Production technologies differ between industries (i.e. one industry will be relatively labour-intensive compared to another)
- Capital and labour are perfectly mobile
- Firms are competitive and suppliers of capital and labour maximise returns and profits
- The total amounts of capital and labour are fixed
- Consumers have identical preferences
- Differential tax incidence provides the framework for the analysis, which means that aggregate income does not change.

[9] Botha, R F, 2004: "Demand for oil on the way up", in *Big Picture June 2004 (internal publication of PricewaterhouseCoopers, SA).*
[10] Harberger, A C, 1974: "Taxation, resource allocation, and welfare", in *Taxation and welfare*, Boston: Little, Brown.

Despite the restrictiveness of these assumptions, the model is useful for analysing the indirect and longer-term effects of a change in the rate of VAT of a particular commodity. Two taxed commodities will be used as examples, namely books and clothing. In the event of lowering the rate of VAT on books, its relative price decreases and consumers are induced to substitute books for clothing. As a result, production of clothing will decline and production of books will increase.

It follows that the utilisation of capital and labour in the clothing industry will be adversely affected. Owners of capital in the clothing industry will attempt to shift unutilised capital to the book industry, leading to a decline in the relative price of this capital. The rules that can be constructed by this analysis are:

- The lowering of a tax on the output of a particular sector induces a decline in the relative price of the input used in a competing sector.
- The greater the difference between capital/labour ratios in two competing industries, the greater will be the decline in the price of capital in the higher-taxed industry.

## Income elasticity of demand

Any amendments to the VAT system will primarily affect demand and supply via the price mechanism. However, price is not the only factor that influences the quantity demanded. In certain cases, the level of disposable income of consumers, as well as changes to these levels, may exercise a greater effect on quantities demanded than marginal adjustments to prices.

At the end of 2006, the South African economy had recorded its 14th successive year of positive real GDP growth, whilst employment growth has also been positive between 2003 and 2006. Against this background, it seems fairly obvious that income levels in the economy would have increased over the past decade, with the rate of increase building up more momentum since 2004. It is regarded as expedient, therefore, to include a brief analysis of the role of income elasticity of demand.

The theory underlying the concept of income elasticity of demand is based on the relationship between a consumer's disposable income and the amount consumed of a particular commodity. Commodity prices are assumed to be constant. This hypothesis was originally developed by Ernst Engel and the graphical relationship is generally referred to as an *Engel* curve. Three different types can be distinguished[11]:

- One where the income elasticity of demand is larger than one.
- One where the income elasticity of demand is smaller than one, but still positive.

[11] Mansfield, E, 1988*: Microeconomics – theory and applications,* London: W W Norton & Company.

- One where the income elasticity of demand is negative.

An *Engel* curve with a positive elasticity may seem like a straightforward economic concept – the more money a consumer has to spend, with prices remaining the same, the more will be the actual expenditure. The intriguing part of *Engel* curve analysis is the fact that the income elasticity of demand can change dramatically as incomes rise and even assume a negative elasticity at some point on the curve.

A typical example of *Engel* curves that may change from being relatively elastic to inelastic (or even negative) is a staple food, whilst an example of the opposite trend would be products such as certain processed foods (smoked fish, confectionery, cheese, etc.).

Any extension of zero-rating of VAT to a particular product will have the effect of increasing disposable income (under the assumption that the product is part of the consumption basket of the consumer). The income elasticity of demand will, however, play an important part in the ultimate determination of the economic incidence of the tax amendment.

# Economic efficiency

## Excess burden

The amount of money whereby a consumer's disposable income is reduced as a result of the imposition of VAT is not the only cost of the particular tax. In terms of the fundamental theory of welfare economics, it can be proven that a consumer's utility is lowered by the imposition of VAT on a product even if the tax raises zero revenue. Commonly referred to as the excess burden of selective commodity taxation, this concept may easily be explained through the basic condition for *Pareto* optimality.

It is tempting to assume that the zero-rating of VAT on a particular product will result in a negative excess burden, i.e. exert a net positive effect on the economy. However, this is not the case due to the fact that selective preferential treatment of commodity taxes (whether they are imposed or removed) disturbs one of the fundamental tenets of welfare economics.

The following example will prove the point. Assume that VAT had been levied at rate *t* on two products, clothes and books. Now books are zero-rated. In terms of the conditions for *Pareto* optimality, the marginal rate of substitution of clothes for books in consumption (*MRScb)* must equal the marginal rate of transformation of clothes for books in production (*MRTcb)*. Due to the tax that remains on clothes, consumers are faced with the following marginal rate of substitution:

$$MRScb = (1+tc)xPc/Pb \qquad (1)$$

Although the consumer is faced with a price of *(1+tc)Pc,* clothing producers receive the difference between this price and the tax, which is *Pc*. The profit-maximising condition for *Pareto* optimality is therefore not disturbed and remains the following:

$$MRTcb = Pc/Pb$$

In all cases where *tc* is positive, the marginal rate of substitution in consumption will exceed the marginal rate of transformation in production. The excess burden that arises is due to a wedge that is driven between what the consumer pays and what the producer receives. It represents the loss in utility as a result of involuntary changes to consumption patterns (due to selective taxation).

At first glance, one may argue that an income tax would be superior to a selective commodity tax for raising state revenue. This is not the case, however, due to the fact that leisure time is utilised by most people. An income tax raises the opportunity cost of being at leisure. Inclusion of leisure time in the consumption basket will clearly also serve to disturb the conditions for *Pareto* optimality.

## Total value added

A further consideration of efficiency in taxation is the impact of changes to the particular mixture of taxes on a country's total value added or aggregate economic output. Most of the advanced and emerging market economies derive the overwhelming majority of government revenues from three sources: Personal income tax (PIT), company tax and VAT. The first two are direct taxes, whilst VAT is an indirect tax

In the event of keeping total revenue fixed and ignoring the effects of government expenditure, a change in the relationship of direct to indirect taxation may affect GDP and also international competitiveness in the following ways:

- First, personal income tax is borne only by those members of society that are formally employed or registered as taxpayers. In a society where large segments of the population receive pensions or find themselves operating in the informal sector, the tax base for this source will tend to be relatively narrow. Further, higher rates of PIT may reduce the motivation to work. Theoretically, the latter effect operates via the so-called substitution effect of the PIT, which reduces the opportunity cost of being at leisure (the latter may, of course, be partly or wholly offset by the income effect, which lowers the level of disposable income).

- Secondly, any increase in the effective rate of tax on private companies will tend to erode the international competitiveness of the country. This occurs through lower shareholder returns. It should also be noted that higher corporate tax directly reduces a firm's financial ability for new capital formation.

- Thirdly, indirect taxes such as VAT are regarded as neutral vis-à-vis the abovementioned effects, as they are borne by all consumers and are levied both on imported goods and locally produced goods.

# Studies on the economic incidence of taxation

The analysis that follows will provide an insight into recent research that is regarded as relevant for the purposes of this study. In addition to the quantification of likely changes to the economic incidence of taxation that was conducted by the research team, a number of authoritative research results (local and international) are also examined.

Efficiency considerations tend to feature exclusively in studies conducted in OECD countries, whilst equity considerations are mostly included in South African based research papers.

## Changing the tax mix – South Africa

In a research paper on the effect of the structure of taxes on economic growth in South Africa (Koch, *et. al*, 2005)[12], the relationship between potential economic growth and fiscal policy was examined.

The analysis was predicated on a model developed by Branson and Lovell (2001)[13], which involved the capturing of unobservable information through a technique called data envelopment analysis. After modifying the estimating functions, the analysis was performed with South African data.

In contrast to the results of other studies (most notably the European Commission QUEST model simulation), Koch, *et. al.* (2005) found that decreased indirect taxation relative to direct taxation is strongly correlated with increased GDP growth potential.

Several caveats to this rather controversial result can be identified (some of which have been raised by the authors themselves). They include the following:

- The relationship between the tax mix and GDP is restricted to *measured* potential GDP and therefore excludes informal sector activity. It is generally accepted that unrecorded economic activity in South Africa constitutes a significant portion of total economic activity and the exclusion of the informal sector reduces substantially the objectivity of the model results. This is

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[12] Koch, S F, Schoeman, N J, and van Tonder, J J, 2005: "Economic growth and the structure of taxes in South Africa: 1960 – 2002", in *South African Journal of Economics, Vol 73:2.*

[13] Branson, J, and Lovell, C A K, 2001: "A growth maximising tax structure for New Zealand", in *International Tax and Public Finance*, Vol 8:2.

exacerbated by the fact that most informal sector agents are not part of the direct taxation base. They are, however, subject to paying VAT on the input side of their supply chain, even though most of these agents are not registered for VAT. They also pay VAT on relevant items in their consumption expenditure baskets.

- The causalities that are found on the expenditure side of the budget are not sufficiently incorporated in the model, i.e. whether government's social delivery policies and expenditures on infrastructure are producing efficiency gains or not.

- The time-series data utilised for the study incorporates a lengthy period during which the South African government dissaved as illustrated by Table 2 and Figure 1. Although substantial progress has been made over the past decade in lowering the level of negative saving by government, current revenue was insufficient to finance current expenditure over the past three decades. Given the relatively subdued influence on value added in the economy by many government activities, the presence of dissavings will tend to distort the model's results.

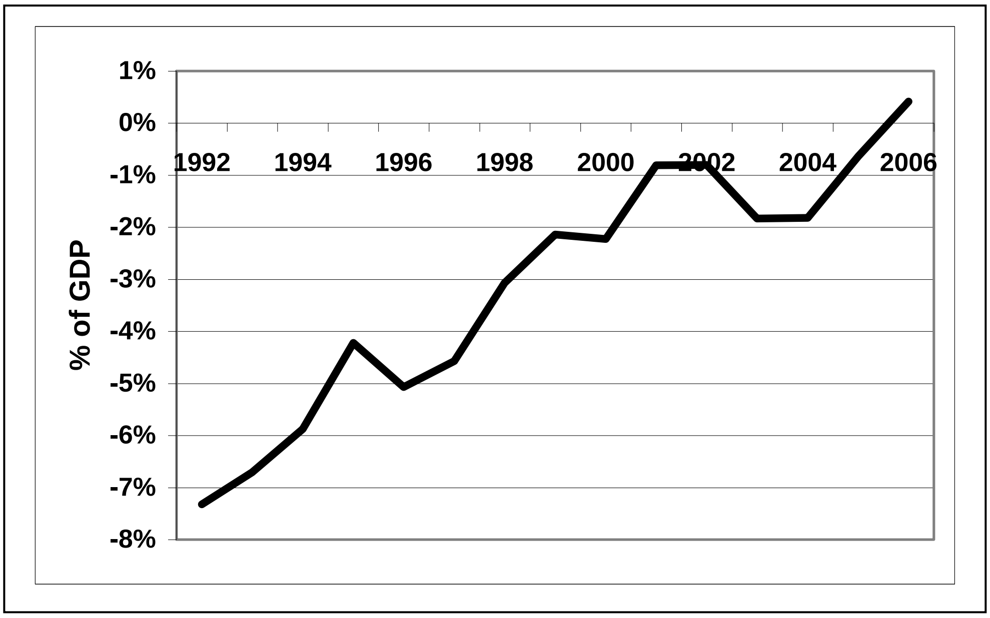
**Table 2: Gross and net saving by general government**

| Gross and net saving by general government | | | | |
|---|---|---|---|---|
| | Gross saving | | Net saving | |
| Year | R billion | % of GDP | R billion | % of GDP |
| 1990 | 1.4 | 0.5% | -6.8 | -2.3% |
| 1991 | -0.9 | -0.3% | -10.2 | -3.1% |
| 1992 | -19.3 | -5.2% | -27.2 | -7.3% |
| 1993 | -19.9 | -4.7% | -28.6 | -6.7% |
| 1994 | -18.8 | -3.9% | -28.3 | -5.9% |
| 1995 | -12.5 | -2.3% | -23.1 | -4.2% |
| 1996 | -19.4 | -3.1% | -31.3 | -5.1% |
| 1997 | -18 | -2.6% | -31.3 | -4.6% |
| 1998 | -7.6 | -1.0% | -22.9 | -3.1% |
| 1999 | -0.4 | 0.0% | -17.4 | -2.1% |
| 2000 | -1.5 | -0.2% | -20.5 | -2.2% |
| 2001 | 12.6 | 1.2% | -8.3 | -0.8% |
| 2002 | 14.1 | 1.2% | -9.4 | -0.8% |
| 2003 | 2.1 | 0.2% | -23.1 | -1.8% |
| 2004 | 1.3 | 0.1% | -25.4 | -1.8% |
| 2005 | 19.7 | 1.3% | -9.8 | -0.6% |
| 2006 | 40.8 | 2.4% | 7.2 | 0.4% |

*Source: South African Reserve Bank*[14]

[14] South African Reserve Bank, 2007*: Quarterly Bulletin,* March 2007.

**Figure 1: Net dissaving/saving by general government as % of GDP**




- Levels of capital formation by government (which tend to exhibit strong efficiency gains), have been extraordinarily subdued during the latter two decades of the time-series, as illustrated by Table 3.

**Table 3: Composition of net capital formation**

| Composition of net capital formation | | |
|---|---|---|
| | Public sector | Private sector |
| 1990 | 0% | 100% |
| 1991 | 5% | 95% |
| 1992 | -186% | 286% |
| 1993 | -158% | 258% |
| 1994 | -34% | 134% |
| 1995 | -8% | 108% |
| 1996 | 2% | 98% |
| 1997 | 12% | 88% |
| 1998 | 41% | 59% |
| 1999 | 8% | 92% |
| 2000 | -2% | 102% |
| 2001 | -2% | 102% |
| 2002 | 2% | 98% |
| 2003 | 18% | 82% |
| 2004 | 17% | 83% |
| 2005 | 21% | 79% |
| 2006 | 23% | 77% |

*Source: SARB*

- No clarity is provided on the distinction between static (short term) effects and dynamic (longer term) effects. Researchers such as Mendoza *et. al.* (1997)[15] and Roeger & De Fiore, (1999)[16] have found that static effects on employment and growth resulting from changes to the tax mix are often ambiguous. Over the longer term, however, significant positive effects ensue from a shift away from income to consumption taxes.

The underlying logic behind the existence of potential efficiency gains from shifting the tax mix away from income is related to the long term effect of the removal of inefficiencies in factor allocation. This flows from the fact that taxation of consumption does not impact on savings. Removal of the fiscal disadvantage on savings that results from an income tax logically leads to a permanently higher accumulation of capital in the long run and hence also higher GDP growth.

## Increasing the VAT rate in South Africa

In a research paper aimed at evaluating the effect of a change in VAT on the economic incidence (particularly as it pertains to poorer income groups) and on government revenue flows, Kearney & van Heerden[17] used a static, computable general equilibrium (CGE) model that included all of the key fiscal revenue sources.

The model was supplemented by a Social Accounting Matrix, in order to balance the macroeconomic equations. After starting with initial equilibrium, the model was then exposed to the effect of an increase in the VAT rate from 14% to 15% and the results were analysed.

The conclusions of this empirical research can be summarised as follows:

- Government revenue increases by 2.5%. (In terms of the 2007 Budget, this would translate into an amount of R13.9 billion, which is substantially more than the total government expenditure on housing in the 2006/07 fiscal year).

- An increase in the VAT rate leads to an increase in the standard of living of lower income groups, mainly as a result of the relatively high propensity for social transfers in the composition of government expenditure. Increased government revenue therefore flows through to the lower income groups in the form of government transfers of social services. Although not explicitly quantified by the model results, one can realistically assume that the model also catered for the effect of expenditure items that are currently zero-rated. This conclusion confirms the effectiveness of the current VAT regime in

[15] Mendoza, E, Milesi-Ferretti, G-M, and Asea, P, 1997: "On the ineffectiveness of tax policy in altering long-run growth: Harberger's superneutrality conjecture", in *Journal of Public Economics,* Vol 66:1.
[16] Roeger, W, and De Fiore, F, 1999: "Growth and employment effects of fiscal regimes" in *Oxford Economic papers*, Vol 51:1.
[17] Kearney, M, and van Heerden J H, 2002: "A static, stylized, CGE model applied to evaluate the incidence of Value Added Tax in South Africa", in *Journal of Economic and Management Sciences.*

addressing the principle of equity and also suggests that further zero-rating is not necessary from an equity perspective.

- The standard of living of the middle and high income groups declines.
- Capital formation in subsequent periods is lowered as a result of increased VAT, which could impact negatively on GDP growth and the demand for labour. Since the model is static, this effect is not accurately quantified.

Kearney & van Heerden[18] therefore recommend that an increase in the VAT rate be considered as part of government's stated intention to alleviate poverty and redistribute income. Although not explicitly stated, this recommendation suggests that the positive effect on GDP growth of increased government expenditure on social services will outweigh the negative effect induced by a lowering of the marginal return on capital investment.

The conclusion relates to the high propensity for social service expenditure by government is vindicated by the data in Table 1, which ranks government expenditure priorities in the post-democracy era. It is clear that welfare expenditure has been afforded the highest priority. This trend is likely to continue with the pending introduction of a contributory savings and retirement scheme (announced in the 2007 Budget).

## The role of saving

In the absence of a taxation base that is expanding at a rate that produces a substantial excess of actual fiscal revenues over budgeted revenue, any additional products or services that are afforded a zero VAT rate will result in a loss of fiscal revenue. In considering the alternatives, a marginal effective increase in the rate of PIT may seem to be a viable option, particularly when viewed against the backdrop of a sustained decline in the ratio of income taxes to total salaries and wages.

The latter achievement represents one of the key tenets of fiscal reform introduced over the past decade and the taxation authorities have been successful in lowering the burden of PIT, particularly at the lower end of the income earning scale. This trend is depicted in Table 4.

Arguments against the use of income tax as a means to augment the revenues forfeited by an expansion of the range of VAT zero-rating, include the fact that such a move would run counter to the stated aim of the National Treasury of income tax relief for salary earners.

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[18] *ibid*.

**Table 4: Ratio of personal income tax to total labour remuneration**

| Ratio of personal income tax to total labour remuneration | | | |
|---|---|---|---|
| **Year** | **Salaries & wages R Billion** | **Personal Income Tax (PIT) R Billion** | **PIT as % of salaries & wages** |
| 1998 | 370.6 | 75.4 | 20.4% |
| 1999 | 402.4 | 84.3 | 21.0% |
| 2000 | 440.3 | 87.8 | 20.0% |
| 2001 | 473.0 | 89.7 | 19.0% |
| 2002 | 519.1 | 96.1 | 18.5% |
| 2003 | 570.9 | 99.2 | 17.4% |
| 2004 | 624.4 | 111.7 | 17.9% |
| 2005 | 676.5 | 123.9 | 18.3% |
| 2006 | 739.0 | 137.1 | 18.6% |

*Sources: National Treasury (2007); SARB (2007)*

Secondly, any increase in the PIT would serve to flatten the slope of the budget constraint between present and future consumption, where the latter is represented on the vertical axis. In practice, this would have the effect of reducing the ability of the individual for future consumption, which has to be financed out of current savings and pensions.

This argument only holds for the savings component that is subject to taxation and operates through a reduction in the effective rate of return on savings (from r to [1-t]r, where r is the rate of return on savings and t is the income tax rate).

It should be noted however, that the lower vertical intercept of the applicable budget constraint does not automatically imply a lower rate of savings. In the case of a so-called “target saver”, savings will actually increase, as this is the only way to insure that a specified value of future consumption can be achieved (e.g. to fund a child’s tertiary education). In the latter case, the so-called income effect dominates, which implies reduced present consumption.

The above analysis is based on the so-called life-cycle model developed by Modigliani (1986)[19], which states that individuals take consumption and savings decisions in a given year with due regard to a planning process during their anticipated lifetime economic circumstances. In a study on US data, King (1993)[20] concluded that as many as 90% of consumers behaved according to the life-cycle hypothesis.

[19] Modigliani, F, 1986: “Life cycle, individual thrift, and the wealth of nations”, in *American Economic Review*, Vol 76:3.
[20] King, R G, 1993: “Will the new Keynesian Macroeconomics resurrect the IS-LM model?” in *Journal of Economic Perspectives*, no 7.

However, in a country characterised by relatively high unemployment and a large degree of income inequality, it can be realistically assumed that the majority of new entrants to the formal labour market will not initially behave in terms of the life-cycle hypothesis. This is apparent from the data depicted by Table 5.

**Table 5: Ratios of interest received to labour remuneration and gross saving to disposable income**

| Ratios of interest received to labour remuneration and gross saving to disposable income | | |
|---|---|---|
| | **Interest/ salaries & wages** | **Savings/ disposable Income** |
| 1998 | 10.4% | 4.8% |
| 1999 | 8.1% | 4.4% |
| 2000 | 6.0% | 4.1% |
| 2001 | 5.9% | 3.8% |
| 2002 | 6.8% | 3.7% |
| 2003 | 6.8% | 3.8% |
| 2004 | 5.0% | 3.3% |
| 2005 | 4.7% | 3.0% |
| 2006 | 5.2% | 2.4% |

*Note: Data for households and non-profit institutions serving households*
*Source: SARB (2007)*[21]

However, Table 6 suggests that households and non-profit institutions have shifted their savings patterns away from interest-bearing investments to equities.

**Table 6: Ratios of interest received to labour remuneration and gross saving to disposable income**

| Interest and dividend receipt trends | | | |
|---|---|---|---|
| **Year** | **Interest/ salaries** | **Dividends/ Salaries** | **Interest & dividends/ salaries** |
| 1998 | 10.4% | 7.6% | 18.1% |
| 1999 | 8.1% | 9.9% | 18.0% |
| 2000 | 6.0% | 11.5% | 17.5% |
| 2001 | 5.9% | 13.4% | 19.3% |
| 2002 | 6.8% | 14.1% | 20.8% |
| 2003 | 6.8% | 11.2% | 18.0% |
| 2004 | 5.0% | 14.1% | 19.1% |
| 2005 | 4.7% | 15.6% | 20.3% |
| 2006 | 5.2% | 15.6% | 20.8% |

*Note: Data for households and non-profit institutions serving households*
*Source: SARB (2007)*

[21] South African Reserve Bank, 2007: *Quarterly Bulletin,* June.

Due to sound company profits in the period 1998 to 2005, the ratio of dividend receipts to labour remuneration has increased substantially. Combined with interest receipts, the proceeds from investments have increased as a ratio of total salaries and wages.

## Summary and conclusion

The purpose of this chapter is to provide an *a priori* framework for determining the likely effects on the economy of changes (specifically exceptions) to the existing VAT dispensation. The framework attempts to establish a set of norms to guide the assessment of changes to the current VAT system. This includes a concise statement of the principles of a sound taxation system.

Where feasible, empirical evidence has been provided (including the results of internal and commissioned microeconomic research) to support the theoretical premises of the analytical tax framework.

Key conclusions arrived at in this section of the study are:

- Due to the acceleration of globalisation, the leeway that fiscal authorities possess in the design of tax systems and policies is being restricted. This is due to highly skilled professionals becoming increasingly internationally mobile, as well as the phenomenon of international convergence that continues to take place with regard to the fundamental components of macroeconomic policy. The latter trend is manifesting itself in marginal to modest differences in the tax regimes, inflation rates, import duties and interest rates between most high-income countries and a growing number of the stable emerging market economies.

- Over the past decade, tax reform towards a lowering of the headline corporate tax rate has been a key feature. Since 2004, a total of 34 countries have reduced profit tax rates on companies, whilst a growing number of countries are reducing the number of taxes and simplifying tax regulations. Between the early 1980s and 2000 the average corporate income tax rate worldwide declined from 46% to 33%, whilst corporate income tax collections increased from 2.1% to 2.4% of national income. An indication that a lowering of rates (up to a point), a broadening of the tax base and more effective enforcements as an important policy framework.

- Modern public finance theory suggest that placing the emphasis of income redistribution on the revenue side of the fiscal equation has been nuanced with a more pragmatic approach, which attempts to emphasise efficiency, thereby raising the maximum amount of revenues required for addressing equity objectives on the expenditure side of the budget (e.g. through grants and subsidised housing).

- A key consideration in any proposed expansion of VAT exemptions or zero-rating is that such measures would lead to a reduction of fiscal revenues. Although the possible amendments under investigation in this study are likely to lead to a rather modest reduction of total fiscal revenues, it could be a point of concern during a downward phase of the business cycle.

- Further amendments to a VAT system that is already subject to fairly extensive differentiation would serve to add to the complexity of the system. This would run counter to the universal fiscal objective of simplicity, which has become one of the tenets of the South African taxation regime.

- In attempting to find solutions for the sub-optimal economic growth performance of the European Union (EU) member states since 1990 (in comparison to both the United States of America and the average for emerging market economies), the Parliament of the EU has commissioned substantial research into the design of growth-enhancing policies. Preliminary empirical evidence suggests that direct taxes reduce the rate of economic growth whilst indirect taxes do not. Alternatively, it has been shown that the net tax burden (as a result of lower levels of disposable income, savings and sub-optimal resource allocation) imposed on society by indirect taxes tends to be lower than in the case of direct taxes.

- The option of increasing personal income tax (PIT) as a means to augment the revenues forfeited by an expansion of the range of VAT zero-rating is not regarded as viable, as it would run counter to the stated aim of the National Treasury of income tax relief for salary earners. Also, any increase in the PIT would serve to reduce an individual income earner’s ability for future consumption, which has to be financed out of current savings and pensions.

- A time-series analysis of trends relating to the composition of fiscal revenues suggests limited leeway for any future increases in the relative shares of company tax, wealth taxes, and selective consumption-based taxes.

# Chapter 2: Analysis of international trends and experience

## Introduction

An awareness of international trends with respect to changes to the structure of VAT systems and the treatment of merit goods and services provides a context to South Africa's own examination of this subject. Many of the issues being confronted in this country are also aspects that have either already been, or are in the process of being, considered by the tax authorities in other countries. While general trends in the international treatment of specific merit goods do not dictate how South Africa should approach these issues, they are relevant if for no other reason than they provide an indication of the extent to which "ideal tax policy" might be forced by political and other considerations to diverge from reality.

This chapter first discusses modern trends in VAT and then examines in detail the VAT treatment of merit goods and services in a large number of tax jurisdictions around the world. The chapter concludes with some of the common trends observed.

## The modern VAT trend

VAT has undoubtedly become the most popular sales tax in the world. It has been called an unparalleled tax phenomenon, which has, like no other tax in history, swept the world from theory to practice.[22] VAT had its origin in France in 1948 and was adopted by the European Community in 1968. Since 1968, VAT has spread to more than 120 countries.[23] Today, it raises about one-fourth of the tax revenue of the world.[24]

### The ideal VAT model

> "A broad–based Value Added Tax ('VAT') is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a very broad provision imposing VAT on an extremely wide range of business transactions and then removing by specific exception any transaction that is not liable."[25]

In a perfect VAT system, the supply of all goods and services is subject to VAT in each stage of the production and distribution chain and double taxation is prevented by way of the input tax mechanism. The result is a broad-based tax on consumption which is easy to administer, to apply, and which yields optimal tax for Government.

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[22] Tait, A A, *Value Added Tax, International Practice and Problems.* International Monetary Fund, Washington, 1988, 1 (hereinafter referred to as 'Tait, Value Added Tax').
[23] Tait, A A*. Broad-based tax on business designed to measure net dollar value generated in a country Value Added Tax, National* The Encyclopaedia of Taxation and Tax Policy, 1 October 1999; 494 – 496. (Hereinafter referred to as "Tait, Broad-based tax").
[24] Ebrill L, Keen M, Bodin JP, Summers V, *The allure of the Value-Added Tax, Finance & Development*, June 2002 Vol 39 No 2.
[25] Victor Thuranyi, ed *Tax Law Design and Drafting*, IMF (1996), vol 1, chapter 6, page 20.

For more than 30 years, the IMF has been advising member countries on the design and implementation of VAT systems. One of the main aims of the IMF has always been that VAT systems should be designed to be as broad-based and pure as possible. Where too many exceptions and concessions are introduced, the risk is high that the VAT system will merely experience the same problems and difficulties which it was designed to eliminate.

Despite the desirability of a broad-based VAT system, fiscal authorities have found it necessary to create exceptions. In some cases such decisions have been motivated to address social policy, fairness, economic neutrality and/or political objectives, while in other cases it has sought to ease the burden of administration. The general perception is however, that such concessions erode the neutrality of the VAT, making it more complex and expensive to administer and increases the opportunities for evasion.[26]

The IMF undertook a major study to answer key questions about the usefulness of VAT and to crystallise best practices. The findings of the IMF were that the spread of the VAT appears to have been broadly desirable, but that the success of a VAT cannot be taken for granted as it requires good design and implementation, not only when first adopted but also for many years thereafter.[27]

The IMF study has also shown that there are several areas in which IMF advice, which was consistent across countries, was not fully accepted. The IMF recommends zero-rating only for exports. But, in practice, zero-rating is widely applied. Exemptions are also used more commonly than advised, thereby undoing, according to the IMF, the good work of VAT in avoiding distortions of input decisions and compromising its transparency. Further, the study has shown that a number of countries use multiple tax rates rather than the single rate that is generally preferred by the IMF. The deviations from the recommended ideal VAT model have, evidently, been influenced by the fact that the ideal theoretical VAT model does not work in the real world. As far back as 1776, Adam Smith stated the first maxim with regard to taxes as being the equality of taxation, namely that the subject of each state ought to contribute towards the support of the government, as nearly as possible, in proportion to the revenue which they respectively enjoy under the protection of the state.[28] Equity, therefore, means that persons in equal circumstances should be treated equally, while people who are not in the same circumstances should be treated differently.[29]

In modern fiscal economics, this fundamental maxim is contained in the requirement that taxes should be progressive in nature, taking into account the ability of the taxpayer to pay the tax. The principle that tax liability should be based on the ability of the person to pay the tax is in most countries accepted as one of the bases of a socially just tax system. However, most countries do not include this requirement of

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[26] Tait, *Broad-based tax op cit* 494 - 496.
[27] . Ebrill et. al. *op cit*.
[28] Smith, A. *The Wealth of Nations,* Bantam Dell, 2003,1043.
[29] Victor Thuranyi, *op cit* .

tax equity in their Constitution, with the result that the requirement cannot be enforced before the court to limit the taxing powers of Government. The ability to pay principle is, nevertheless, constitutionally binding in some countries such as Italy, Spain and Germany.[30]

The Constitution of the Republic of South Africa, 1996, provides that everyone is equal before the law and has the right to equal protection and benefit of the law.[31] To promote the achievement of equity, legislative and other measures designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination may be taken.[32] While these provisions appear to relate to benefits and protection rather than the obligation to pay tax, the protection against a liability to pay tax which a person cannot afford is inherently part of a the right of the person to equity. This right of tax equity has, indeed, through the years been recognised in South Africa, for example with regard to progressive income taxation as well as transfer duty, estate duty, sales tax and VAT concessions made to promote the progressivity of the tax system.

If the essential aim of equity of taxation cannot be achieved, the tax is regarded as being regressive in nature and thus undesirable.

## Regressivity of VAT

The regressivity of VAT is probably one of the most debated and researched controversial issue relating to VAT in all countries. It is commonly feared that the VAT adversely affects the distribution of real income. But the IMF argues that rather than any one tax, it is the tax system as a whole, taken in conjunction with public spending policies that affects poverty and fairness. According to IMF studies, a regressive tax could, in theory, be the best way to finance pro-poor spending, which more than offsets any anti-poor effect of the tax itself.[33]

There are relatively few studies of VAT in developing countries, but the IMF contends that there is growing evidence that it is not an especially regressive tax. For example, studies for Côte d'Ivoire, Guinea, Madagascar and Tanzania all show that the poor pay less than their share of total consumption as their share of total VAT revenues. It has also been argued that many of those who perceive the VAT as particularly regressive are likely to be comparing it to a progressive personal income tax - a comparison of little relevance given the difficulties that some developing countries experience in administering an effective personal income tax.

Studies undertaken by the IMF have shown that few taxes are well suited to pursuing equity objectives. Expenditure policies are regarded as often being a better means of achieving these aims, though the capacity for well-targeted spending measures is

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[30] Victor Thuranyi, *op cit* 8.
[31] Section 9(1).
[32] Section 9(2).
[33] Ebrill *op cit* .

very limited in many low-income countries. While the scope for pursuing distributional objectives on the spending side should not be taken for granted, experience has clearly demonstrated that the first duty of taxation must normally be to raise needed revenues with as little distortion of economic activity as possible (except where the stated intention is to try and correct certain market failures).

Another argument is that the distribution of the burden of a consumption tax such as VAT will, over a lifetime, approximate the distribution of the burden of a broad income tax, because over a lifetime people consume all the resources they have, except for gifts and inheritances. On this basis, a VAT need not necessarily be more regressive than an income tax, so long as wealth transfers are also taxed.[34]

In an attempt to promote progressivity of the VAT system, Governments may ensure that certain supplies are not afforded special treatment, or may even tax the supplies at a higher VAT rate. However, due to the administrative and compliance difficulties caused multiple VAT rates, other non-VAT methods might rather be used to promote progressivity, such as excise duties.

As it would be totally impractical to provide that no VAT is to be paid by people whose income is below a certain threshold, in line with income tax principles, the basic necessities which form part of lower income households' expenditure and consumption are often identified as requiring relief to eliminate regressivity. Such an approach can, obviously, not eliminate VAT regressivity in totality, as consumption patterns of the poor also differ, making it difficult to determine what constitutes basic necessities. Further, basic necessities are not only consumed by the poor. This latter fact is clearly illustrated by the analysis of household spending patterns in South Africa contained in Chapter 5 of this study.

For these reasons, the IMF and advocates of a broad-based VAT system argue that regressivity of VAT should not be addressed through the VAT system, but by way of targeted social assistance programmes.

## Merit goods or services

In justifying VAT concessions aimed at specified goods or services, it is often also argued that certain goods or services are so 'meritorious' that they should not be subject to VAT, or at least, should qualify for concessionary VAT treatment. Further, where goods or services cannot be said to be basic necessities, resulting in the argument of VAT regressivity not necessarily applying, lobby groups would argue that the goods or services qualify for concessionary treatment on merit grounds. The arguments that are used to prove the meritorious nature of the goods or services include the following:[35]

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[34] Raboy, DG, Hamond J & Shapiro R J. *Enterprise Economics IV: The Case for and against Vale-Added Taxation,* 1 July 1995.

[35]Tait*, Value Added Tax op cit* 69 – 79*.*

- The goods or services are in the public interest;
- The goods or services are essential;
- Poorer households should not have to pay VAT on the goods or services;
- Direct targeted budgetary assistance is not capable of ensuring that the goods or services can be supplied to everyone;
- The goods or services are of a cultural nature;
- The goods or services are of an educational nature and taxation thereof would amount to a tax on knowledge; or
- The goods or services can, from a political point of view, not be taxed.

In principle, a concession based on meritorious grounds should be a blanket one and should not be concerned with equity principles and aimed at alleviating regressivity. For example, where Government wants to enable consumers to purchase more of certain items, a VAT concession for these products would be motivated by the meritorious nature of the goods or services.

However, in many instances, the classification of goods as merit goods which should not be subject to VAT at all, is influenced by the fact that the goods or services is unaffordable to lower income groups or that it is unjust to expect of the poor to pay VAT thereon. A mixture of arguments justifying the lobbying for concessionary VAT treatment thus arises. Therefore, unless it can purely be argued that the nature of goods or services is such that all users or consumers thereof should receive concessionary VAT treatment, the goods or services are not merit goods or services, but the concession is rather justified on the basis of the negative impact of regressivity and the lack of the social assistance programmes to provide relief. The practice has, however, developed to refer to goods or services qualifying for VAT relief, as 'merit goods or services', probably due to the academic and technical nature of the concept regressivity. A reference to "merit goods or services thus includes a reference to goods or services which deserve special VAT treatment to promote equity of taxation.

It has also been argued that there are only two grounds for freeing goods or services from VAT, namely social policy and complexities of administration.[36] VAT concessions motivated by social policy would thus include concessions to reduce VAT regressivity and to promote some of the other objectives listed above. VAT concessions to reduce complexities of administration are also referred to as concessions for difficult-to-tax goods or services.

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[36] Shoup, C, *The Value Added Tax and Developing Countries*,145

## Difficult-to-tax goods or services

In addition to requests for concessionary treatment due to the impact of regressivity or the meritorious nature of the goods or services, or a mixture of these grounds, Governments are often faced with so-called difficult-to-tax goods or services or industries, resulting in a concession for an industry or specific supplies in the industry. However, difficult-to-tax supplies are often also covered by regressivity and merit goods or services arguments, such as in the case of farmers.[37]

Governments usually exempt financial services, due to the difficulty in determining the value added in the industry.[38] The payments made and flows of money in that industry cannot merely be regarded as consideration for the supply of goods or services, due to the impact of the long term growth in money, inflation and interest. However, poor households, who do not use or have access to the financial services industry and who do not understand the complexities involved with the taxation of the financial sector, might perceive a VAT exemption as a concession to the more affluent using these services. Where these poorer households are struggling to pay for the most basic necessities such as food, water, electricity and clothing, knowing that they must also pay VAT on these supplies, these households may be tempted to lobby for special concessionary treatment for basic goods or services, on the grounds of regressivity. Such a situation could have political implications where lobby groups exploit the ignorance of these households for their own political agendas. Where concessions are thus made on difficult-to-tax grounds, without being justified on regressivity or meritorious grounds, Government should inform and educate the public as to the reasons for the concessions and the other forms of taxation imposed on these industries, in lieu of VAT, to prevent further requests for VAT concessions.

Where the complexities of VAT administration would be too onerous for a certain sector, Government might decide to rather exclude the persons making these supplies from the ambit of VAT, or to make certain concessions to alleviate the administrative burden of VAT.

## Policy considerations

When requesting concessionary VAT treatment, lobby groups and other interested parties will normally opt for the most favourable VAT treatment. Governments, on the other hand, will naturally consider the cost of potential concessions. However, prior to weighing up the monetary advantages and disadvantages of a specific form of concession, any potential concession should be evaluated against the background of the important policy considerations that were outlined in Chapter 1 and which are restated below.

[37] Tait, *Broad-based tax op cit* 56.
[38] Tait , *Value-Added Tax op cit* 92.

### *Equity*

Notwithstanding the sound fiscal policy advice and recommendations regarding the inefficiency of VAT concessions, the reality is that Governments are often faced with political pressure and large scale poverty and unemployment. Targeted assistance may not be sufficiently effective to counter balance the perceived regressivity of a VAT system. Many requests for concessions, such as exemptions or zero-rating of certain goods or services or the application of reduced VAT rates are inherently motivated by social policy considerations, which are aimed at promoting equity.

It could thus be argued that adherence to requests for concessions aimed at promoting equity may be socially justified and laudable. However, it is evident from the analysis in Chapter 5 that the actual impact of such concessions is often the exact opposite of what is being pursued.

While a concession might, in theory, rectify inequalities in the VAT system, a request for a concession cannot be evaluated against this policy goal in isolation, as it might then be at risk of disregarding the other essential tax policy considerations.

### *Neutrality*

A neutral VAT system should not distort consumer preferences and producer choices, discriminate between goods or services, affect the choice of production and distribution channels or interfere with market allocations of resources. It is widely believed that a VAT system is capable of meeting these objectives of neutrality, but only if a single rate of VAT is applied, without the common exceptions for various basic goods such as food, health care and housing.[39]

When specific goods or services enjoy concessionary VAT treatment, these goods or services could be cheaper, resulting in a shift in consumer choices and ultimately in a shift in producer preferences.

If input tax credits are not allowed for the inputs of businesses, the amount of VAT ultimately paid would depend on the length of the production or distribution chain, as “VAT on VAT cascading” would occur, thus affecting the neutrality of the tax. This is a serious negative implication of exemptions in the VAT system.

Neutrality of export products is also essential to ensure competitiveness of exporters of a country in international markets.

### *Simplicity and efficiency*

A further essential policy consideration relates to simplicity of the VAT system. The VAT system should be able to collect large amounts of money in the simplest and

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[39] Raboy, DG, Hamond J & Shapiro R J. *Enterprise Economics IV: The Case for and against Value-Added Taxation,* 1 July 1995.

cheapest manner.[40] The VAT system should not increase administrative and compliance costs for the taxpayer or the revenue authority.

Furthermore, the VAT system should not negatively affect economic growth, production or employment opportunities, such as where a lack of neutrality results in distortion of vested market patterns.

### *Certainty*

The VAT system should ensure certainty as to the amount of VAT payable, when it is payable and when any exceptions apply. The legislation needs to clearly and unambiguously state which goods or services are subject to VAT or not, without creating opportunities or incentives for VAT evasion and fraud.

In allowing concessions to alleviate the real or perceived impact of regressivity or to remove or reduce the impact of VAT on merit goods, a Government should take care that the concessions do not complicate the VAT system by increased administrative costs associated with more personnel required to implement and/or administer the concessions, or due to ambiguities in and uncertainties created by, the legislation allowing the concession. The nature of the concession and the potential difficulties should be carefully considered, as the general perception is that such concessions erode the neutrality of the VAT, making the law more complex and expensive to administer with an increased opportunity for evasion.[41]

The impact which VAT concessions will have on these essential policy considerations are considered below.

## Concessionary VAT treatment

### *Zero-rating*

Zero-rating the supply of goods or services creates the most favourable VAT treatment, as no VAT is charged on the supply of the qualifying goods or services and no hidden VAT cost arises due to the fact that the supplying vendor may deduct VAT incurred by him to make the relevant supplies as input tax.

Governments will tend not to allow a zero-rating for the very reason that no VAT yield is achieved. Zero-rating is therefore applied when a Government wants to pass on the benefit of VAT-free goods or services to the consumer, such as in the case of exports.[42] The Netherlands was the first country to allow zero-rating of exports, in order to remove all VAT costs from exports.[43] In fact, the IMF recommends that zero-rating be limited to exports, to tax only local consumption, in adherence with the

[40] In general, VATCOM Report *op cit* 7.
[41] Tait , *Broad-based tax op cit* 494 - 496
[42] Tait, Broad-based Tax op cit 51.
[43] Tait, *Broad-based Tax op cit* 53.

destination-based VAT principle. It has, however, also been argued that where a Government wants to introduce relief measures as part of its social policy, a zero-rating should be used, as that is the only way in which complete unburdening of VAT could be achieved.

Zero-rating results in an advantage in international trade, in the poor being not taxed at all or relatively less than the well-to-do, and encourage and facilitate production by not forcing a reduction in certain kinds of personal consumption.[44]

### *Exemption*

An exemption from VAT does not totally unburden the goods or services from the impact of VAT, as the supplier of the goods or services cannot deduct the VAT incurred on goods or services acquired to make the exempt supply as input tax.

It has been argued that exemptions could be used to provide relief from VAT when the problem is the complexity of administration. In practice, however, exemptions are used for specific goods or services, while administrative difficulties usually do not occur in respect of particular types of goods or services, but rather particular industries or service providers. This approach has been criticised on the basis that social problems experienced in respect of particular basic goods or services cannot be eliminated by freeing the goods or services from VAT at just one stage of the production or distribution chain, with trapped VAT costs forming part of the price structure.[45]

In contrast to the perception that exemptions are regarded as alleviating administrative difficulties, exemptions often create costly and complex administrative difficulties. Where a vendor makes exempt and taxable supplies, an exemption will increase his administrative cost, as he will have to distinguish between taxable supplies and exempt supplies for purposes of charging VAT to customers and he will have to make appropriate apportionment calculations in determining his deductible input tax.

### *Lower VAT rates*

Tait[46] has argued that, due to the disadvantages of introducing exemptions or zero-ratings, especially the perception that certain industries are given preferential VAT treatment with the resultant requests for further concessions, it may be better to implement a reduced VAT rate.

Where lower rates are allowed it is expected that the rate should not be so low that it fails to absorb the deductions due for the VAT paid by the vendor on his inputs. The lower rate should thus still result in a positive VAT liability, instead of the State

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[44] Shoup *op cit* 146.
[45] Shoup *op cit*, 145.
[46] Tait, *op cit*, 51.

making net refunds to the vendor.[47] Where lower rates do not result in a positive VAT liability, the lower rate will effectively subsidise the product, although to a lesser extent than in the case of a zero-rating.

The European Commission recently investigated the impact of reduced VAT rates applying to locally supplied services.[48] The Commission argues that while there is a strong general argument for having uniform VAT rates in the European Union there are exceptions as there are real and valid economic arguments for extending lower VAT rates to some very specific sectors in member states characterised by specific economic structures. The study examines the theoretical and empirical merits of four different arguments for reduced VAT rates:[49]

1 There is a convincing theoretical and empirical argument for extending reduced VAT rates to sectors whose services are easily substituted for do-it-yourself or underground work, e.g. locally supplied services and some parts of the hospitality sector. The argument is that high VAT rates make it very expensive to buy these services on the market and more attractive to do yourself. Lower VAT rates serve to counter this development.

2 There is a theoretical but not an empirical argument for extending reduced VAT rates to sectors employing many low skill workers in order to boost low skill demand. Reduced VAT rates, by boosting demand for such services, stimulate demand for low skill workers and push up their wages so that employment becomes a more attractive option than unemployment.

3 It is claimed that there is a limited argument for extending reduced VAT rates to sectors particularly favoured by low income households in order to improve the income distribution. The argument however, only holds for member states with significant and stable consumption differences between high and low income groups. It is argued that the only relevant sector is food. But the Commission argues that extending reduced VAT rates to food also brings about significant complications such as compliance costs.

4 Further, it is claimed that there is a limited and contingent argument for extending reduced VAT rates to sectors that for some (good) reason are under-consumed. The motivation can be to make cultural (merit) goods more available for low income households, such as in the case of books, music and cultural events. The argument is that demand can be boosted on any product by lowering VAT rates. The Commission is of the view, however, that it is often difficult to verify whether low income households in reality are induced to purchase more merit goods or whether the lower rates in reality serves as a subsidy to high income households initially consuming more merit goods.

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[47] *As* to lower rates in the European Union, see below. In general ,Tait *Broad-based tax op cit* 51.
[48] Study on reduced VAT applied to goods and services in the Member States of the European Union, European Commission, 21 June 2007. See http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm.
[49] *Ibid 4 – 6.*

The Commission concluded that while there seems to be a strong argument for making the current VAT structure more simple and uniform, there is also an argument for selective cuts in VAT rates primarily in locally supplied services and parts of the hospitality sector. The Commission stressed the fact that the current study cannot be seen as a per se endorsement for further reductions in VAT and that each case has to be considered on its own merits to appraise whether alternative non-VAT instruments may be preferable to reduced VAT rates.

## VAT treatment of merit goods or services

The international VAT treatment of the merit goods and services identified for purposes of this study, namely medical services and medicines, educational services and reading matter, as well as municipal services, is analysed[50] below.

All the analysis below indicates zero-rating in the column marked '0%', exemption in the column marked 'X' and lower VAT rates in the column marked '↓%'. The classification of the VAT treatment is based on general principles, without reference to specific requirements or exceptions.

### Africa

Although economically better off than most other African countries, South Africa has to deal with the same social and economical problems as the rest of the continent. The approach of Governments in Africa to the VAT treatment of certain merit goods and services is therefore relevant during any investigation into VAT reform of merit goods or services in South Africa. The standard VAT rate, as well as concessionary VAT treatment in respect of the relevant merit goods or services in certain African countries, are summarised in the tables below.

#### *Medical services and medicines*

Poverty, unemployment and the resultant health issues still form part of the legacy of South Africa. HIV/AIDS, malaria, tuberculosis and other deadly diseases are a threat to millions of people on the African continent, who continuously experience ill health due to a lack of sufficient and healthy food and medical services and medicines. Some knowledge of the VAT treatment of medical services and medicines in Africa would thus provide a background for evaluating the VAT treatment thereof in South Africa.

[50] It should be noted that a selection of countries has been used for purposes of this comparative study.

**Table 7: VAT treatment of medical services and products in Africa**

| Country | Std % | Medical services | | | Pharmaceutical products | | | Medical equipment | | | Organs & blood | | | Products for disabled | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **AFRICA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Botswana** | 10 | | X | | | X | | | | | | | | | | |
| **Cameroon** | 17.5 | | X | | | | | | | | | | | | | |
| **Chad** | 18 | | X | | | | | | | | | | | | | |
| **Congo** | 18 | | X | | | X | | | | | | | | | | |
| **Equatorial Guinea** | 15 | | X | | | | | 0 | | | | | | | | |
| **Gabon** | 18 | | | | | | | | | | | | | | | |
| **Ghana** | 12.5 | | | | | X | | | | | | | | | X | |
| **Ivory Coast** | 18 | | X | | | | | | | | | | | | | |
| **Kenya** | 16 | | X | | 0 | | | | | | | | | | | |
| **Lesotho** | 14 | | X | | | X | | | | | | | | | | |
| **Madagascar** | 18 | | X | | | X | | | | | | | | | | |
| **Malawi** | 17.5 | | X | | | X | | | X | | | | | | | |
| **Mauritius** | 15 | | X | | | X | | | | | | | | | | |
| **Morocco** | 20 | | X | | 0 | | | | | | | | | | | |
| **Mozambique** | 17 | | X | | | X | | | | | | X | | | X | |
| **Namibia** | 15 | | X | | | | | | | | | | | | | |
| **Nigeria** | 10 | | X | | | X | | | | | | | | | | |
| **Senegal** | 18 | | X | | | | | | | | | | | | | |
| **South Africa** | 14 | | | | | | | | | | | | | | | |
| **Tanzania** | 20 | | X | | 0 | X | | | | | | | | 0 | | |
| **Tunisia** | 18 | | | | | X | | | | | | | | | | |
| **Uganda** | 18 | | X | | 0 | | | | X | | | | | | | |
| **Zambia** | 17.5 | | X | | 0 | | | | | | | | | | | |
| **Zimbabwe** | 15 | | X | | 0 | | | | | | | | | 0 | | |

*Sources of basic data: Global VAT Online,*[51] *Overview of VAT in Africa*[52]

The trends in these 24 African countries, which were included in this comparison, can be summarised as follows:

- Medical services are exempt from VAT in 20 of these countries;
- Medicines are allowed relief in 17 of these countries, with an exemption applying in 11 countries and a zero-rating applying in 6 countries;
- While the standard VAT rates of the African countries are generally higher than in South Africa, relief for medical services and medicines are also provided in the countries with lower VAT rates, namely Botswana, Ghana and Nigeria; and
- It should be noted that the relief for medical services is in some countries limited to supplies by the state or other non-profit bodies. Due to the structure of the South African VAT legislation, supplies of medical services by provincial hospitals are also not subject to VAT, as the services are not supplied by VAT registered vendors. Therefore, while the South African VAT Act does not provide for an exemption of medical services as in the case of

[51] See www.globalvatonline.com.
[52] PricewaterhouseCoopers *Overview of VAT in Africa,* (May 2007).

the VAT Acts of countries allowing an exemption of medical services provided by the State or non-profit bodies, the net VAT effect would be the same.

### *Educational services, books, newspapers and journals*

Education is the foundation of any civilisation. While many South Africans still suffer from the discriminatory education policies of the previous regime, education and books are in certain cases still expensive for many others. Education is equally important in the developing economies of the rest of Africa. Their VAT treatment of education, educational matter and other books, newspapers and journals is summarised below:

**Table 8: VAT treatment of educational services and reading matter in Africa**

| Country | Std% | Educational services | | | Newspapers | | | Journals / Magazines | | | Educational material only | | | Books (general) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **AFRICA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Botswana** | 10 | | X | | | X | | | | | | | | | X | |
| **Cameroon** | 17.5 | | X | | | X | | | X | | | | | | | |
| **Chad** | 18 | | X | | | X | | | X | | | | | | | |
| **Congo** | 18 | | X | | | | | | | | | X | | | | |
| **Equatorial Guinea** | 15 | | X | | | X | | | X | | | X | | | | |
| **Gabon** | 18 | | X | | | X | | | | | | X | | | | |
| **Ghana** | 12.5 | | X | | | X | | | | | 0 | | | | X | |
| **Ivory Coast** | 18 | | X | | | | | | | | | | | | | |
| **Kenya** | 16 | | X | | 0 | | | 0 | | | | | | 0 | | |
| **Lesotho** | 14 | | X | | | | | | | | | | | | | |
| **Madagascar** | 18 | | X | | | | | | | | | | | | | |
| **Malawi** | 17.5 | | X | | | | | | | | 0 | | | | X | |
| **Mauritius** | 15 | | X | | | X | | | | | 0 | | | 0 | | |
| **Morocco** | 20 | | X | | | X | | | | | | | | | X | |
| **Mozambique** | 17 | | X | | | X | | | X | | | X | | | X | |
| **Namibia** | 15 | | X | | | | | | | | | | | | | |
| **Nigeria** | 10 | | X | | | X | | | | | | | | | X | |
| **Senegal** | 18 | | X | | | | | | | | | | | | | |
| **South Africa** | 14 | | X | | | | | | | | | | | | | |
| **Tanzania** | 20 | | X | | | X | | | | | | | | | X | |
| **Tunisia** | 18 | | X | | | | | | | | | | | | X | |
| **Uganda** | 18 | | X | | | | | | | | 0 | | | | | |
| **Zambia** | 17.5 | | X | | | X | | | | | | | | | X | |
| **Zimbabwe** | 15 | | X | | | | | | | | | | | | | |

*Sources of basic data: Global VAT Online, Overview of VAT in Africa*

The trends in these African countries can be summarised as follows:

- Educational services are exempt in all these countries;
- Many countries allow relief for books, newspapers and journals;
- It should, however, be borne in mind that the zero-rating or exemption is often limited to newspapers with minimum prescribed distribution periods, prescribed maximum advertising content and prohibitions of the exemption to

items that are of an erotic nature. The need for these requirements is indicative of the difficulties associated with defining the merit goods which warrant special VAT treatment.

### *Municipal services*

Basic municipal services are essential for every human being, but especially for the upliftment and upgrading of informal settlements in South Africa and the rest of Africa. Without clean water, entire communities face health risks. Without electricity, the standard of living of the communities and standard of education of the children is limited.

**Table 9: VAT treatment of municipal services in Africa**

| Country | Std% | Water: general | | | Water: Only domestic / limited consumption | | | Electricity: general | | | Electricity: Only domestic / limited consumption | | | Sewerage / drainage | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **AFRICA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Botswana** | 10 | | | | | | | | | | | | | | | |
| **Cameroon** | 17.5 | | | | | X | | | | | | X | | | | |
| **Chad** | 18 | | | | | X | | | | | | X | | | | |
| **Congo** | 18 | | | | | | | | | | | | | | | |
| **Equatorial Guinea** | 15 | | | | | | | | | | | | | | | |
| **Gabon** | 18 | | | | | | | | | | | | | | | |
| **Ghana** | 12.5 | | | | | X | | | | | | X | | | | |
| **Ivory Coast** | 18 | | | | | | | | | | | | | | | |
| **Kenya** | 16 | | | | | | | | | | 0 | | | | X | |
| **Lesotho** | 14 | | X | | | | | | | 5 | | | | | | |
| **Madagascar** | 18 | | | | | | | | | | | | | | | |
| **Malawi** | 17.5 | | X | | | | | | | | | | | | | |
| **Mauritius** | 15 | 0 | | | | | | 0 | | | | | | | | |
| **Morocco** | 20 | | | 7 | | | | | | 14 | | | | | | |
| **Mozambique** | 17 | | | | | | | | | * | | | | | | |
| **Namibia** | 15 | | | | 0 | | | | | | 0 | | | | | |
| **Nigeria** | 10 | | | | | | | | | | | | | | | |
| **Senegal** | 18 | | | | | | | | | | | | | | | |
| **South Africa** | 14 | | | | | | | | | | | | | | | |
| **Tanzania** | 20 | | | | | X | | | | | | | | | | |
| **Tunisia** | 18 | | | | | | | | | | | | | | | |
| **Uganda** | 18 | | | | | | | | | | | | | | | |
| **Zambia** | 17.5 | | X | | | | | | | | | | | | X | |
| **Zimbabwe** | 15 | | X | | | | | | | | | X | | | | |

Mozambique: 17% on electricity is charged on 62% of the invoice total amount.

*Sources of basic data: Global VAT Online, Overview of VAT in Africa*

The trends in these African countries can be summarised as follows:

- While clear trends cannot be identified, some countries provide relief for water and electricity;

- Relief is in some instances limited to domestic or household consumption, but other countries provide relief to all sectors; and

- Bottled water is generally excluded from the scope of relief.

### *Funeral services*

An analysis of concessionary treatment of merit goods by African countries have revealed that funeral and cremation services qualify for exemption in 7 countries.

**Table 10: VAT treatment of funeral services in Africa**

| Country | Std % | Funeral or cremation services | | |
|---|---|---|---|---|
| **AFRICA** | | **0%** | **X** | **↓%** |
| **Botswana** | 10 | | | |
| **Cameroon** | 17.5 | | | |
| **Chad** | 18 | | | |
| **Congo** | 18 | | | |
| **Equatorial Guinea** | 15 | | | |
| **Gabon** | 18 | | | |
| **Ghana** | 12.5 | | | |
| **Ivory Coast** | 18 | | | |
| **Kenya** | 16 | | X | |
| **Lesotho** | 14 | | | |
| **Madagascar** | 18 | | | |
| **Malawi** | 17.5 | | X | |
| **Mauritius** | 15 | | X | |
| **Morocco** | 20 | | | |
| **Mozambique** | 17 | | X | |
| **Namibia** | 15 | | | |
| **Nigeria** | 10 | | | |
| **Senegal** | 18 | | | |
| **South Africa** | 14 | | | |
| **Tanzania** | 20 | | X | |
| **Tunisia** | 18 | | | |
| **Uganda** | 18 | | X | |
| **Zambia** | 17.5 | | X | |
| **Zimbabwe** | 15 | | | |

*Sources of basic data: Global VAT Online, Overview of VAT in Africa*

## VAT reform in Africa during the past five years

### *Kenya*

In the last two years budget utilities like water and basic goods like milk, wheat flour and maize meal were added to the zero-rated listing after various submissions in past years.

### *Uganda*

1 Exemption for milk was replaced by a zero-rating during 2002. Exemptions inserted during 2001 include the supply of unimproved land; the supply of feeds for poultry and livestock; the supply of machinery used for the processing of agricultural or dairy products; and the supply of photosensitive semiconductor devices, including photovoltaic devices, whether or not

assembled in modules or made into panels; light emitting diodes; solar water heaters and solar cookers.

2 Exemption added during 2002: The supply of accommodation in tourist lodges and hotels outside Kampala and Entebbe;

3 Exemptions added during 2003: The supply of computer software; the supply of lifejackets, life saving gear, headgear and speed governors; the supply of mobile toilets and Ekoloo toilets made from polyethylene; and the supply of insecticides;.

4 Exemption added during 2005: The supply of feasibility studies, engineering designs and consultancy services and civil works related to roads and bridges' construction; and

5 Zero-rating added during 2001: The supply of machinery, tools and implements suitable for use only in agriculture.

### *Mozambique*

The supply of medical services by private entities became exempt from VAT under Decree 47 of 21 December 2001. Before that date only medical services provided by public entities were exempt.

## European Union and Western Europe

VAT legislation of member countries of the European Union must conform to the basic guidelines of the European Commission's Directive 2006/112/EC (which replaced the Sixth Directive (Directive 77/388/EEC) with effect from 1 January 2007). Title IX of Directive 2006/112/EC deals with exemptions. Chapter 2 thereof provides for exemptions for certain activities in the public interest. The provisions of Articles 132, 133 and 134 are quoted in Annexure 2.

Studies of the impact of reduced rates in EU member states have shown that for several of the States the number of authorised deviations from the standard rules distort their VAT base. In 2000, on average for all the EU member states, 69% of the value of taxable transactions was taxed at the standard VAT rate. It has been found that for some member states only around half of the whole taxable base is subject to the standard VAT rate.[53]

Any provision for an exemption or a lower VAT rate should be viewed in the perspective of the member state's standard VAT rate. The following table provides a summary of the standard VAT rate as well as the application of the guidelines of Directive 2006/112/EC (previously the Sixth Directive) by EU member states. For

[53] European Commission, Taxation Papers: VAT Indicators, Working Paper 2 of 2004, 21.

ease of reference, the VAT treatment of the relevant goods or services in non-EU countries in Western Europe are also summarised in the tables[54] below:

### *Medical services and medicines*

**Table 11: VAT treatment of medical services and products in the European Union and Western Europe**

| Country | Std % | Medical services | | | Pharmaceutical products Medicines | | | Medical equipment | | | Organs & blood | | | Products for disabled | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EU & WESTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Austria** | 20 | | X | | | | | | | | | | | | | |
| **Belgium** | 21 | | X | | | | 6; 12 | | | 6 | | | | | | |
| **Bulgaria** | 20 | | X | | | | | | | | | | | | | |
| **Cyprus** | 15 | | X | | | | | | | | | | | | | |
| **Czech Rep** | 19 | | X | 5 | | | 5 | | | 5 | | | | | | 5 |
| **Denmark** | 25 | | X | | | | | | | | | | | | | |
| **Estonia** | 18 | | X | | | | 5 | | | 5 | | | | | | |
| **Finland** | 22 | | X | | | | 8 | | | | | | | | | |
| **France** | 19.6 | | X | | | | 2.1 | | | | | | | | | |
| **Germany** | 19 | | X | | | | | | | | | X | | | | |
| **Greece** | 19 | | X | | | | 9 | | | 9 | | | | | | |
| **Hungary** | 20 | | X | | | | 5 | | | 5 | | | | | | |
| **Ireland** | 21 | | X | | 0 | | | 0 | | | | | | | | |
| **Italy** | 20 | | X | | | | 10 | | | | | | | | | |
| **Latvia** | 18 | | X | | | | 5 | | | 5 | | X | | | | 5 |
| **Lithuania** | 18 | | X | | | | 5 | | X | | | X | | | | |
| **Luxembourg** | 15 | | X | 3 | | | | | | | | | | | | |
| **Malta** | 18 | | X | | 0 | | | | | 5 | | | | | | 5 |
| **Netherlands** | 19 | | X | | | | 6 | | | | | | | | | 6 |
| **Norway** (non- EU) | 25 | | X | | | | | | | | | | | | | |
| **Poland** | 22 | | X | | | | 7 | | | | | | | | | |
| **Portugal** | 21 | | X | 5 | | | 5 | | | | | X | | | | 5 |
| **Romania** | 19 | | X | | | | 9 | | | | | | | | | |
| **Slovak Rep** | 19 | | X | | | | 10 | | | 10 | | | | | | |
| **Slovenia** | 20 | | X | | | | 8.5 | | | 8.5 | | | | | | 8.5 |
| **Spain** | 16 | | X | 7 | | | 4 | | | 7 | | | | | | 7; 4 |
| **Sweden** | 25 | | X | | 0 | | | | | | | | | | | |
| **Switzerland** (non-EU) | 7.6 | | X | | | | 2.4 | | | | | X | | | | |
| **UK** | 17.5 | | X | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

The trends in these European countries can be summarised as follows:

- All 29 these countries exempt medical services, in line with Directive 2006/112/EC;

[54] Zero-rating is indicated in the column marked '0%', exemption in the column marked 'X' and lower VAT rates in the column marked '↓%'. The classification of the VAT treatment is based on general principles, without reference to specific requirements or exceptions.

- The lower rates for medicines, which are allowed by 21 of these countries, are generally less than 50% of the standard rate applied by the country, resulting in considerable relief being granted for medicines. These lower rates should, however, be evaluated in the context of the generally high standard VAT rates; and

- Some countries allow lower rates for medical equipment and products for the disabled.

### *Educational services, books, newspapers and journals*

**Table 12: VAT treatment of educational services and reading matter in the European Union and Western Europe**

| Country | Std % | Educational services | | | Newspapers | | | Journals / Magazines | | | Books | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EU & WESTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Austria** | 20 | | X | | | | | | | | | | 10 |
| **Belgium** | 21 | | X | | 0 | | 6 | 0 | | 6 | | | 6 |
| **Bulgaria** | 20 | | X | | | | | | | | | | |
| **Cyprus** | 15 | | X | | | | 5 | | | 5 | | | 5 |
| **Czech Rep** | 19 | | X | | | | 5 | | | 5 | | | 5 |
| **Denmark** | 25 | | X | | 0 | | | | | | | | |
| **Estonia** | 18 | | X | | | | 5 | | | 5 | | | 5 |
| **Finland** | 22 | | X | | 0 | | | 0 | | | | | 8 |
| **France** | 19.6 | | X | | | | 2.1 | | | | | | 5.5 |
| **Germany** | 19 | | X | | | | 7 | | | 7 | | | 7 |
| **Greece** | 19 | | X | | | | 4.5 | | | 4.5 | | | 4.5 |
| **Hungary** | 20 | | X | | | | 5 | | | 5 | | | |
| **Ireland** | 21 | | X | | | | 13.5 | | | 13.5 | 0 | | |
| **Italy** | 20 | | X | | | | 4 | | | | | | 4 |
| **Latvia** | 18 | | X | | | | | | | | | | 5 |
| **Lithuania** | 18 | | X | | | | 5 | | | 5 | | | 5 |
| **Luxembourg** | 15 | | X | | | | 3 | | | | | | 3 |
| **Malta** | 18 | | X | | | | | | | | | | 5 |
| **Netherlands** | 19 | | X | | | | 6 | | | 6 | | | 6 |
| **Norway** (non EU) | 25 | | X | | 0 | | | | | | 0 | | |
| **Poland** | 22 | | X | | | | 7 | | | | | | |
| **Portugal** | 21 | | X | | | | 5 | | | 5 | | | 5 |
| **Romania** | 19 | | X | | | | 9 | | | 9 | | | 9 |
| **Slovak Rep** | 19 | | X | | | | | | | | | | |
| **Slovenia** | 20 | | X | | | | 8.5 | | | 8.5 | | | 8.5 |
| **Spain** | 16 | | X | | | | 4 | | | 4 | | | 4 |
| **Sweden** | 25 | | X | | | | 6 | | | 6 | | | 6 |
| **Switzerland** (non-EU) | 7.6 | | X | | | | 2.4 | | | | | | 2.4 |
| **UK** | 17.5 | | X | | 0 | | | 0 | | | 0 | | |

*Source of basic data: Global VAT Online*

The trends in these European countries can be summarised as follows:

- All 29 these countries allow exemption of educational services;

- Only 2 countries do not provide some form of VAT relief for reading matter;

- Books are taxed at lower rates (of less than 50% of the standard rate) by nearly all countries;

- Lower rates or zero-rating of books, newspapers and journals is normally not limited to educational books only, but restrictions regarding advertising content and erotic content may apply.

### *Municipal services*

**Table 13: VAT treatment of municipal services in the European Union and Western Europe**

| Country | Std % | Water: general | | | Water: Domestic / limited consumption | | | Electricity: general | | | Electricity: Domestic / limited consumption | | | Sewerage / drainage | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EU & WESTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Austria** | 20 | | | | | | | | | | | | | | | |
| **Belgium** | 21 | | | | | | | | | | | | | | | |
| **Bulgaria** | 20 | | | | | | | | | | | | | | | |
| **Cyprus** | 15 | | | 5 | | | | | | | | | | | | |
| **Czech Rep** | 19 | | | 5 | | | | | | | | | | | | |
| **Denmark** | 25 | | | | | | | | | | | | | | | |
| **Estonia** | 18 | | | | | | | | | | | | | | | |
| **Finland** | 22 | | | | | | | | | | | | | | | |
| **France** | 19.6 | | | 5.5 | | | | | | | | | | | | |
| **Germany** | 19 | | | | | | | | | | | | | | | |
| **Greece** | 19 | | | 9 | | | | | | 9 | | | | | | |
| **Hungary** | 20 | | | | | | | | | | | | | | | |
| **Ireland** | 21 | | | | | | | | | 13.5 | | | | | | 13.5 |
| **Italy** | 20 | | | | | | | | | | | | 10 | | | |
| **Latvia** | 18 | | | 5 | | | | | | 5 | | | | | | 5 |
| **Lithuania** | 18 | | | | | | 5 | | | | | | 5 | | | |
| **Luxembourg** | 15 | | | | | | | | | 6 | | | | | | |
| **Malta** | 18 | | X | | | | | | | 5 | | | | | | |
| **Netherlands** | 19 | | | 6 | | | | | | | | | | | | |
| **Norway** (non-EU) | 25 | | | 14 | | | | | | | | | | | | |
| **Poland** | 22 | | | 7 | | | | | | | | | | | | |
| **Portugal** | 21 | | | | | | | | | | | | 5 | | | |
| **Romania** | 19 | | | | | | | | | | | | | | | |
| **Slovak Rep** | 19 | | | | | | | | | | | | | | | |
| **Slovenia** | 20 | | | 8.5 | | | | | | | | | | | | |
| **Spain** | 16 | | | 7 | | | | | | | | | | | | 7 |
| **Sweden** | 25 | | | | | | | | | | | | | | | |
| **Switzerland** (non-EU) | 7.6 | | | | | | | | | | | | | | | |
| **UK** | 17.5 | | | | 0 | | | | | | | | 5 | 0 | | |

*Source of basic data: Global VAT Online*

The trends in these European countries can be summarised as follows:

- Some form of relief is provided by 17 of these countries, notably by way of lower rates, in respect of water and electricity;

- Relief is more often allowed for water than electricity; and
- The lower rates should be evaluated in the context of the high standard rates.

### *Funeral or cremation services*

**Table 14: VAT treatment of funeral or cremation services in the European Union and Western Europe**

| Country | Std % | Funeral / cremation services | | |
|---|---|---|---|---|
| **EU & WESTERN EUROPE** | | **0%** | **X** | **↓%** |
| **Austria** | 20 | | | |
| **Belgium** | 21 | | | |
| **Bulgaria** | 20 | | | |
| **Cyprus** | 15 | | | 5 |
| **Czech Rep** | 19 | | | 5 |
| **Denmark** | 25 | | | |
| **Estonia** | 18 | | | 5 |
| **Finland** | 22 | | | |
| **France** | 19.6 | | | |
| **Germany** | 16 | | | |
| **Greece** | 19 | | | |
| **Hungary** | 20 | | | 15 |
| **Ireland** | 21 | | X | |
| **Italy** | 20 | | | |
| **Latvia** | 18 | | | 5 |
| **Lithuania** | 18 | | | |
| **Luxembourg** | 15 | | | |
| **Malta** | 18 | | | |
| **Netherlands** | 19 | | X | |
| **Norway** (non-EU) | 25 | | | |
| **Poland** | 22 | | | |
| **Portugal** | 21 | | X | |
| **Romania** | 19 | | | |
| **Slovak Republic** | 19 | | | |
| **Slovenia** | 20 | | | 8.5 |
| **Spain** | 16 | | | 7 |
| **Sweden** | 25 | | | |
| **Switzerland** (non-EU) | 7.6 | | | |
| **UK** | 17.5 | | X | |

*Source of basic data: Global VAT Online*

It is evident that less than half of these countries provide relief for funeral or cremation services, notably by way of lower rates.

## Eastern Europe

The standard VAT rate, as well as concessionary VAT treatment in respect of the relevant merit goods or services in certain Eastern European countries, are summarised in the tables below.

### *Medical services and medicines*

**Table 15: VAT treatment of medical services and other products in Eastern Europe**

| Country | Std% | Medical services | | | Pharmaceutical products | | | Medical equipment | | | Organs & blood | | | Products for disabled | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EASTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Azerbaijan** | 18 | | | | | | | | | | | | | | | |
| **Croatia** | 22 | | X | | 0 | | | | | | 0 | | | | | |
| **Russian Federation** | 18 | | X | | | | 10 | | | | | | | | | |
| **Turkey** | 18 | | | 8 | | | 8 | | | 8 | | | 8; 1 | | | |
| **Ukraine** | 20 | | | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

The relief, which is generally allowed for medical services and other products in these Eastern European countries, should be viewed in the light of the relatively high standard VAT rates.

### *Educational services, books, newspapers and journals*

**Table 16: VAT treatment of educational services and reading matter in Eastern Europe**

| Country | Std % | Educational services | | | Newspapers | | | Journals / Magazines | | | Books | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EASTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Azerbaijan** | 18 | | | | | X | | | | | | X | |
| **Croatia** | 22 | | | | | | | | | | 0 | | |
| **Russian Federation** | 18 | | X | | | | | | | 10 | | | 10 |
| **Turkey** | 18 | | | 8 | | | 1 | | | 1 | | | 8 |
| **Ukraine** | 20 | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

While some relief is allowed for educational services and reading matter in these Eastern European countries, clear trends cannot be identified.

### *Municipal services*

**Table 17: VAT treatment of municipal services in Eastern Europe**

| Country | Std% | Water: general | | | Water: Only domestic / limited consumption | | | Electricity: general | | | Electricity: Domestic / limited consumption | | | Sewerage / drainage | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EASTERN EUROPE** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Azerbaijan** | 18 | | | | | | | | | | | | | | | |
| **Croatia** | 22 | | | | | | | | | | | | | | | |
| **Russian Federation** | 18 | | | | | | | | | | | | | | | |
| **Turkey** | 18 | | | | | | | | | | | | | | | 8 |
| **Ukraine** | 20 | | | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

Except for one instance, no relief is allowed for municipal services.

### *Funeral or cremation services*

**Table 18: VAT treatment of funeral or cremation services in Eastern Europe**

| Country | Std % | Funeral / cremation services | | |
|---|---|---|---|---|
| **EASTERN EUROPE** | | **0%** | **X** | **↓%** |
| **Azerbaijan** | 18 | | X | |
| **Croatia** | 22 | | | |
| **Russian Federation** | 18 | | | |
| **Turkey** | 18 | | | 1 |
| **Ukraine** | 20 | | | |

*Source of basic data: Global VAT Online*

Some relief is allowed for funeral or cremation services.

## Americas

The United States of America does not have a VAT system. The VAT treatment of the relevant merit goods or services in various other American countries might not have convincing value for purposes of this study, but the overview in the tables below nevertheless provide useful data for purposes of comparison.

### *Medical goods and services*

**Table 19: VAT treatment of medical services and other products in the Americas**

| Country | Std % | Medical services | | | Pharmaceutical products | | | Medical equipment | | | Organs & blood | | | Products for disabled | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **AMERICAS** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Argentina** | 21 | | | 10,5 | | X | | | | | | | | | | |
| **Barbados** | 15 | | X | | | | | | | | | | | | | |
| **Bolivia** | 13 | | | | | | | | | | | | | | | |
| **Canada** | 6 | | X | | 0 | | | | | | | | | | | |
| **Colombia** | 16 | | X | | | | | | | | | | | | | |
| **Ecuador** | 12 | 0 | | | 0 | | | | | | | | | | | |
| **Honduras** | 12 | | X | | | X | | | | | | | | | | |
| **Mexico** | 15 | | X | | 0 | | | | | | | | | | | |
| **Panama** | 5 | | X | | | X | | | | | | | | | | |
| **Peru** | 19 | | | | | | | | | | | | | | | |
| **Trinidad and Tobago** | 15 | | X | | 0 | | | | | | | | | | | |
| **Uruguay** | 23 | | X | | | | 14 | | | | | | | | | |

*Source of basic data: Global VAT Online*

The trends in these American countries can be summarised as follows:

- The range of standard VAT rate in these 12 countries varies from 5% to 23%;
- Relief is allowed for medical services in 10 of these countries, notably by way of exemption;
- Relief is not limited to countries with high standard VAT rates; and
- Relief is allowed for medicines in 8 of these countries, either by way of zero-rating or exemption.

### *Education, books, newspapers and journals*

**Table 20: VAT treatment of educational services and reading matter in the Americas**

| Country | Std % | Educational services | | | Newspapers | | | Journals / Magazines | | | Educational material only | | | Books (general) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Americas** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Argentina** | 21 | | | | | | | | | | | X | | | | |
| **Barbados** | 15 | | | | | | | | | | | | | | | |
| **Bolivia** | 13 | | | | | | | | | | | | | | | |
| **Canada** | 6 | | X | | | | | | | | | | | | | |
| **Colombia** | 16 | | X | | | | | 0 | | | 0 | | | | | |
| **Ecuador** | 12 | 0 | | | 0 | | | 0 | | | | | | 0 | | |
| **Honduras** | 12 | | X | | | X | | | X | | | | | | X | |
| **Mexico** | 15 | | X | | 0 | X | | | X | | | | | 0 | X | |
| **Panama** | 5 | | X | | | X | | | X | | | | | | | |
| **Peru** | 19 | | | | | | | | | | | | | | | |
| **Trinidad and Tobago** | 15 | | X | | | | | | | | | | | | | |
| **Uruguay** | 23 | | | | | X | | | X | | | X | | | X | |

*Source of basic data: Global VAT Online*

The trends in these 12 American countries can be summarised as follows:

- 6 of the countries allow exemption and 1 allows zero-rating of educational services; and
- 7 of the countries allow relief for books, newspaper and journals, more often by way of exemption.

### *Municipal services*

**Table 21: VAT treatment of municipal services in the Americas**

| Country | Std% | Water: general | | | Water: Only domestic / limited consumption | | | Electricity: general | | | Electricity: Domestic / limited consumption | | | Sewerage / drainage | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Americas** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Argentina** | 21 | | | | | | | | | | | | | | | |
| **Barbados** | 15 | | X | | | | | | | | | | | | | |
| **Bolivia** | 13 | | | | | | | | | | | | | | | |
| **Canada** | 6 | | | | | | | | | | | | | | | |
| **Colombia** | 16 | | | | | | | | X | | | | | | X | |
| **Ecuador** | 12 | | | | | | | | | | | | | | | |
| **Honduras** | 12 | | X | | | | | | X | | | | | | X | |
| **Mexico** | 15 | | | | | | | | | | | | | | | |
| **Panama** | 5 | | X | | | | | | | | | | | | X | |
| **Peru** | 19 | | | | | | | | | | | | | | | |
| **Trinidad and Tobago** | 15 | | | | | | | | | | | | | | | |
| **Uruguay** | 23 | | X | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

While some relief is allowed for municipal services in 5 of these American countries, clear trends cannot be identified.

### *Funeral or cremation services*

The American countries do not allow VAT relief for funeral or cremation costs.

## Asia

In view of the important trade relations South Africa has with various Asian countries, as well as health and poverty related problems experienced by some Asian countries, an overview of the VAT treatment of the relevant merit goods and services in some Asian countries, as summarised in the tables below, provides useful data for purposes of comparison.

## *Medical services and medicines*

**Table 22: VAT treatment of medical services and other products in Asia**

| Country | Std% | Medical services | | | Pharmaceutical products | | | Medical equipment | | | Organs & blood | | | Products for disabled | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **ASIA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Australia** | 10 | 0 | | | 0 | | | | | | | | | | | |
| **Cambodia** | 10 | | X | | | X | | | | | | | | | | |
| **China** | 17 | | | | | X | | | | | | | | | X | |
| **Fiji** | 12,5 | | | | 0 | | | | | | | | | | | |
| **India** | 12.5 | | | | | X | | | | | | | | | | |
| **Indonesia** | 10 | | X | | | | | | | | | | | | | |
| **Japan** | 5 | | X | | | | | | | | | | | | X | |
| **New Zealand** | 12.5 | | | | | | | | | | | | | | | |
| **Papua New Guinea** | 10 | | X | | 0 | | | 0 | | | | | | | | |
| **Philippines** | 12 | | X | | | | | | | | | | | | | |
| **Singapore** | 7 | | | | | | | | | | | | | | | |
| **South Korea** | 10 | | X | | | | | | | | | X | | | | |
| **Taiwan** | 5 | | X | | | | | | | | | | | | | |
| **Thailand** | 7 | | X | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

The trends in these 14 Asian countries can be summarised as follows:

- The standard VAT rates in these countries (except for China) are lower than the VAT rate in South Africa;
- Relief is provided for medical services in 9 of these countries, notably by way of exemption; and
- Only 6 of these countries provide relief for medicines, either by way of zero-rating or exemption.

### *Education, books, newspapers and journals*

**Table 23: VAT treatment of educational services and reading matter in Asia**

| Country | Std % | Educational services | | | Newspapers | | | Journals / Magazines | | | Educational books / material only | | | Books (general) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **ASIA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Australia** | 10 | 0 | | | | | | | | | | | | | | |
| **Cambodia** | 10 | | | | | | | | | | | | | | | |
| **China** | 17 | | | | | | 13 | | | 13 | | | | | X | 13 |
| **Fiji** | 12,5 | | X | | | | | | | | | | | | | |
| **India** | 12.5 | | | | | | | | | | | | | | | |
| **Indonesia** | 10 | | X | | | | | | | | | | | | | |
| **Japan** | 5 | | X | | | | | | | | | X | | | | |
| **New Zealand** | 12.5 | | | | | | | | | | | | | | | |
| **Papua New Guinea** | 10 | | X | | | | | | | | | | | | | |
| **Philippines** | 12 | | X | | | X | | | X | | | | | | X | |
| **Singapore** | 7 | | | | | | | | | | | | | | | |
| **South Korea** | 10 | | X | | | X | | | X | | | | | | X | |
| **Taiwan** | 5 | | X | | | | | | | | | | | | | |
| **Thailand** | 7 | | X | | | X | | | X | | | X | | | | |

*Source of basic data: Global VAT Online*

In summary :

- Relief is provided for educational services in 9 of these 14 countries, notably by way of exemption; and
- Only 5 of these countries provide relief for reading matter.

### *Municipal services*

**Table 24: VAT treatment of municipal services in Asia**

| Country | Std % | Water: general | | | Water: Only domestic / limited consumption | | | Electricity: general | | | Electricity: Domestic / limited consumption | | | Sewerage / drainage | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **ASIA** | | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** | **0%** | **X** | **↓%** |
| **Australia** | 10 | | | | | | | | | | | | | | | |
| **Cambodia** | 10 | | | | | | | | X | | | | | | | |
| **China** | 17 | | | | | | 13 | | | | | | 13 | | | |
| **Fiji** | 12,5 | | | | | | | | | | | | | | | |
| **India** | 12.5 | | X | | | | | | | | | | | | | |
| **Indonesia** | 10 | | | | | X | | | | | | X | | | | |
| **Japan** | 5 | | | | | | | | | | | | | | | |
| **New Zealand** | 12.5 | | | | | | | | | | | | | | | |
| **Papua New Guinea** | 10 | | | | | | | | | | | | | | | |
| **Philippines** | 12 | | | | | | | | | | | | | | | |
| **Singapore** | 7 | | | | | | | | | | | | | | | |
| **South Korea** | 10 | | X | | | | | | | | | | | | | |
| **Taiwan** | 5 | | | | | | | | | | | | | | | |
| **Thailand** | 7 | | | | | | | | | | | | | | | |

*Source of basic data: Global VAT Online*

While some relief is allowed for municipal services in 5 of these 14 Asian countries, clear trends cannot be identified.

### *Funeral or cremation services*

Of the countries included in the study, only Japan allows relief for cremation costs, by way of an exemption.

## Evaluation of international trends

Any relief for merit goods or services allowed by other countries should, in the first instance, be evaluated against the background of their VAT rates. A comparison of the VAT rates which apply in the different regions has revealed the following trends:

- With the exception of Botswana, Nigeria, Ghana and Lesotho, the VAT rates in the African countries, which have been studied, are higher than the standard rate in South Africa, but the standard rate does not exceed 20%;
- The VAT rates in Western and Eastern Europe are generally higher than the VAT rate of South Africa, generally ranging from 15% to 25%;
- The VAT rates applying in the American countries, which have been studied, are diverse, ranging from 5% to 23%; and

- The VAT rates in the Asian countries are lower than the VAT rate in South Africa, with the exception of China at 17%.

The provision of VAT relief for the relevant merit goods or services should therefore be viewed against the background of generally higher VAT rates. On the other hand, there are a number of countries with lower VAT rates which also provide some form of VAT relief, for at least some merit goods or services. Further, the lower VAT rates which are allowed for certain merit goods or services in the European Union, are much lower than the applicable standard VAT rates, thus resulting in the provision of considerable VAT relief.

The trend however, is that the scope of the relief is limited in various instances. For example, the exemption of medical services is often limited to services provided by state-operated or other non-profit institutions. While a specific exemption is provided for in such a case, an effective exemption applies to the supply of medical services by the state in South Africa, as the Department of Health and the Provincial hospitals are not registered as VAT vendors.

The study has revealed that the supply of educational services is regarded as meritorious of relief in all regions. However, it is evident that the relief for educational services nearly always take the form of an exemption. Lower rates are in certain instances allowed for reading matter, although exemptions and zero-ratings are also applied by some countries. While relief for reading matter is not as common as the exemption of educational services, it is clear that relief is not limited to so-called developing countries with lower literacy levels, but is also allowed in well-developed countries with high education levels.

Many countries provide various forms of relief for municipal services, especially water and electricity for domestic consumption. However, clear and definite trends could not be identified in this regard.

Funeral or cremation services have been identified as enjoying relief in some countries, and have therefore been included in the comparative tables above, although a clear global trend on this issue could not be identified.

While not specifically included within the scope of this study, the study of the VAT treatment of merit goods or services on a global level has resulted in the identification of various goods or services which are meritorious for the people of a specific country. For example, many countries provide some relief for tourist-related services or specific essential industries, e.g. coffee, tea or oil. A few countries provide relief for baby food or products. Further, it is evident that the scope of basic foodstuffs qualifying for special VAT treatment is diverse, differing from country to country, with even salt qualifying for special relief.

The existence of concessionary treatment in other countries might result in lobbying for similar relief in South Africa. Policy-makers should thus be aware of such precedents and the potential impact thereof on expectations for similar VAT concessions. However, the mere fact that a supply of specific goods or services qualify for relief in another country, or that VAT concessions have become a trend on the global VAT front, cannot constitute a sound base for the introduction of similar relief in South Africa.

## Conclusion

The global VAT experience indicates that most countries provide some form of relief for merit goods or services, especially medical services and medicines, while relief is also often given in respect of books, newspapers and journals. Some trends indicate that developing countries provide VAT concessions for books, newspapers and journals, which could indicate a desire to promote general education. However, an analysis of the trends in Europe has indicated that relief is also provided in these developed countries. In the United Kingdom, for example, a zero-rating is allowed for these supplies. It should be borne in mind, however, that the VAT rates in these countries are higher than in South Africa.

In conclusion, it is clear that most countries had to make some concessions in respect of merit goods and services, whether to offset the perceived regressivity of their VAT system or to promote consumption of specific merit goods or services.

# Chapter 3: Policy considerations at the introduction of VAT

## Introduction

The starting point of any investigation into the appropriateness of VAT reform should be an analysis of the policy considerations which applied and the decisions taken when VAT was introduced.

VAT was introduced 16 years ago in South Africa by the previous Government in a political dispensation diverse from today and in a substantially different economic climate . Therefore, an understanding of the motivation for and philosophy surrounding the current treatment of the merit goods or services under consideration is essential to determine whether changed circumstances and times justify (or necessitate) VAT reform regarding the VAT treatment of the merit goods or services.

Some of the main reasons advanced for the transition from a GST system to a VAT system were the unpopularity and extent of evasion of sales tax, the probability of improving recovery under a VAT system and the extent of the erosion of the sales tax base due to exemptions relating to foodstuffs.[55] The Government was also advised and assisted by the IMF regarding the design of a VAT model for South Africa and the implementation of a VAT.

VATCOM[56] stated that it was important to have a productive and reliable tax system to produce revenue for the creation of equal opportunities, dealing with socio-economic backlogs and the financing of programmes which would increase the income generating abilities of individuals on a broad front. A broad-based VAT system was believed to be one of the most reliable and fairest tax instruments available to achieve that goal.[57]

One of the disadvantages of the GST system, compared to the VAT system, was said to be the fact that the GST base was narrower than total consumption, as basic foodstuffs and most services were excluded from the ambit of the tax.[58] While acknowledging that a VAT system does not meet the essential requirement of equity, due to the regressive nature of the tax, it was stated that experience throughout the world had shown that favoured treatment of goods or services or groups of consumers by any of the means available through the VAT system, was ill-advised. It was said that concessions by means of exemptions, zero-rating or reduced rates are relatively ineffective means of helping lower income groups as these concessions distort consumer preferences and producer choices, cause problems of defining the ambit of the concession and increase the cost of administration and compliance of the tax. It was thus concluded that it was intention of the Government to restrict these

[55] The Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa, (1994), 103. This report is hereinafter referred to as the 'Katz Interim Report'. Subsequent reports are referenced by number of report.
[56] Published on 18 June 1990.
[57] Tthe Report of the Value-Added Tax Committee (VATCOM) (1991) 6. This report is hereinafter referred to as the VATCOM Report
[58] *Ibid* 2.

concessions to a minimum.[59] The needy should be assisted as far as possible outside the tax system, by means of budgetary assistance in the form of targeted government spending.

Despite the recommendations by VATCOM to Government to implement the ideal VAT model in South Africa, without any concessions or relief measures, the numerous representations regarding certain meritorious goods and services had to be considered and dealt with. The general approach by VATCOM to all the requests for concessions remained that a broad-based VAT system should be implemented with targeted assistance being granted outside the VAT system. This approach was also followed when the final version of the Value-Added Tax Act 89 of 1991 ('the VAT Act') was drafted.

However, due to mounting resistance to the introduction of VAT, caused by its anticipated negative impact on the poor, Government had to consider various possibilities to satisfy the public and other critics. On 21 August 1991, the then Minister of Finance, Mr Barend Du Plessis issued a media statement as a result of the rising opposition to the introduction of VAT, scheduled for 30 September 1991. After confirming that the introduction of VAT would not be cancelled or postponed, he once again reiterated that the introduction of a variety of VAT exemptions and zero-ratings to assist the poor would place VAT on the same dangerous road as sales tax, which as a result of the many exceptions which were allowed, did not meet the criteria of an effective tax system. It was added that a proliferation of tax concessions would cause precisely the problem which it is intended to eliminate, namely that the greatest benefit would be enjoyed by those who do not need it. He then announced that it had nevertheless been decided to make certain adjustments that would still maintain the integrity of the VAT system and would extend targeted assistance in such a way as to achieve immediate results.[60] The first concession related to the rate of VAT. Further concessions eventually had to be made prior to the commencement date of 30 September 1991, as outlined below.

## VAT rate

The impact of VAT on merit goods or services is necessarily affected by the rate of VAT, regardless of the application of any concession. The higher the rate of VAT, the higher is the burden on low income earners.

When the Draft VAT Bill was published for comment, Government had not yet determined the standard rate of VAT.[61] As evidence was given to VATCOM that a rate of 10 per cent would be acceptable to the public, VATCOM recommended that, while the fixing of the VAT rate would be a budgetary consideration, the rate should be as low as possible to ensure public acceptance.[62] Prior to the introduction of VAT,

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[59] *Ibid* 3 – 4.
[60] Media Statement by the Minister of Finance, Mr Barend Du Plessis, of 21 August 1991.
[61] Clause 7(1) of the Draft VAT Bill merely provided for VAT calculated at the rate of x per cent.
[62] VATCOM Report *op cit* 10.

Government decided to introduce VAT at the standard rate of 12 per cent[63], but in an attempt to allow direct relief for the anticipated impact of VAT, Mr Barend Du Plessis announced on 21 August 1991 that VAT would be introduced at the rate of 10 per cent. The VAT rate was however, increased to 14% on 7 April 1994.

## Basic foodstuffs

The Draft VAT Bill did not contain any relief for basic foodstuffs. Numerous representations were made to VATCOM, arguing that the needy would be adversely affected by an increase in the costs of foodstuffs, which again would have an effect on the demand for these goods and consequently, also have an impact on the producers of the goods. VATCOM argued that the use of a tax system to achieve social objectives such as providing relief to the needy by exempting basic foodstuffs is a very inefficient means, unless the exemption is restricted to foodstuffs which are used predominantly or exclusively by the needy. In addition, any special relief would create opportunity for evasion of VAT (as was experienced under the GST system) as well as difficulties of defining the goods qualifying for relief and administrative and system costs to businesses.[64]

VATCOM recommended that a limited number of goods which were already exempt from GST, (e.g. maize products, rice, bread and milk powder), be zero-rated. It was further recommended that budgetary assistance be provided to the needy outside the tax system to compensate them for the increase of costs due to the introduction of VAT.[65]

When the VAT Act was promulgated on 12 June 1991, no special provision was made for basic foodstuffs. However, due to political pressure, an amendment providing for the zero-rating of brown bread and maize meal was introduced with effect from 17 July 1991.[66] In his Media Statement of 21 August 1991, Mr Barend Du Plessis announced an adjustment to social assistance schemes to social pensioners to further soften the effect of VAT on the needy.[67]

The zero-rating of only two basic foodstuffs still did not satisfy public demand and the Government had to make further last minute concessions to prevent the introduction of VAT being jeopardised by political unrest. The Minister of Finance issued a Media Statement on 29 September 1991 (the Sunday before the scheduled introduction of VAT on Monday 30 September 1991) that the following basic foodstuffs would also be zero-rated, for a period of six months until 31 March 1992: Samp, mealie-rice, whole mealies for human consumption, dry beans, lentils, fresh milk, canned

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[63] Section 23 of the Taxation Laws Amendment Act 136 of 1991, which was promulgated on 17 July 1991.
[64] VATCOM Report *op cit* 15.
[65] VATCOM Report *op cit* 14 – 16.
[66] Clause 27(f) Taxation Laws Amendment Act 136 of 1991 which was promulgated on 17 July 1991, prior to the commencement date of 30 September 1991.
[67] It was stated that the adjustment would in most cases amount to approximately R10 per month.

pilchards for human consumption, powdered milk and dairy powder blends and rice.[68] The intention was that adequate targeted social assistance programmes would have been put in place by 31 March 1992. However, further pressure resulted in the zero-rating of these basic foodstuffs being introduced on a permanent basis.[69]

## Educational services, books, newspapers and journals

The Draft VAT Bill provided that primary, secondary and tertiary educational services provided by the State and certain institutions would be exempt from VAT.[70] According to VATCOM, the decision to exempt educational services was motivated by the importance of education in South Africa, and the fact that the cost of providing these services is to a greater or lesser extent was financed by the State. It was further argued if educational services were to be subject to VAT, then some 21 000 educational institutions in South Africa would have to account for VAT and submit VAT returns. It was said that this would increase the administrative costs of these organisations which are not geared to comply with taxation laws, without any net gain for the fisc. It was also argued that the zero-rating of educational services would place these educational institutions in a better position than they were under sales tax, however it would reduce the VAT base, and further place an administrative burden on these institutions to keep VAT records.

VATCOM, accordingly, concluded that the provision of pre-primary, primary, secondary and tertiary education be exempt from VAT.[71] The VAT Act[72] provided for the exemption of the supply of educational services by the State and specified educational institutions, as well as the supply by these institutions of goods or services which are necessary for and subordinate and incidental to the supply of the educational services, where these goods or services are covered by school fees, tuition fees or boarding fees.[73]

Representations were made to VATCOM that the supply of books, newspapers, magazines and the services of the electronic media are of an educational nature and should be afforded special treatment such as zero-rating, exemption or lower rates. It was argued that subjecting these goods and services to VAT would amount to a tax on knowledge. VATCOM argued that all books, newspapers and magazines are not entirely educational. To determine which of them are meritorious for special treatment would result in difficulties of defining the specific printed or electronic media which qualify for special VAT treatment. VATCOM concluded, in line with its

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[68] The zero-rating, for the six-month period, was regulated by clause 25 of Government Notice No 2695 of Government Gazette 13627 of 8 November 1991.
[69] Media Statement issued by Mr Barend Du Plessis on 31 March 1992. The zero-rating of these foodstuffs is contained in section 11(1)(j) read with Part B of Schedule 2 to the VAT Act.
[70] Clause 12(h) of the Draft Value-Added Tax Bill published on 18 June 1990 in Government Gazette No 12514.
[71] VATCOM Report *op cit* 22 – 24.
[72] Which was promulgated on 12 June 1991.
[73] Section 12(h) of the VAT Act.

general recommendation of a broad-based tax with the minimum exceptions, that it was difficult to justify special treatment of the supply.

No special concession was introduced in the VAT Act which was promulgated on 12 June 1991. Only the supply of books and other printed or electronic media which are supplied as part of educational services, and which are covered by school or tuition fees is exempt from VAT.[74]

## Medical services and medicine

The Draft VAT Bill provided for the exemption of services provided by registered medical practitioners, dentists, dieticians, optometrists, homeopaths, naturopaths, osteopaths, herbalists, nurses, physiotherapists, psychologists, chiropractors, masseurs and orthoptists. The supply of goods necessary for and subordinate and incidental to the supply of these professional services were also proposed to be exempt. Further, the supply of services, or goods necessary for and subordinate and incidental to the supply of the services, in a registered hospital or nursing home or services provided in a clinic conducted by a local authority were similarly proposed to be exempt from VAT. The supply of medicine, except those provided for use during the consultation, the supply of prostodontic goods (by a dentist) and spectacles or contact lenses would, however, be subject to VAT.[75]

Medical professionals opposed the proposed exemption on the basis that they would experience administrative and apportionment difficulties due to professionals supplying exempt medical services and taxable supplies of medicines, spectacles or other goods or services. In addition, it was argued that the wider VAT base (compared to the then existing sales tax base) would result in additional VAT costs which would inevitably have to be borne by the practitioners, as fees could not merely be increased. These professionals called for the zero-rating of medical services or, alternatively preferred standard rating to an exemption.[76] Hospitals were also concerned about the impact of VAT on costs which could not be passed on to patients and also requested a zero-rating, but nevertheless preferred the exemption above a standard rating, in the interest of their patients.[77]

VATCOM further considered the fact that the poor are to a large extent assisted through provincial hospitals and clinics where their financial situation is taken into account in determining the amount they must pay for medical services and medicines.[78]

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[74] Section 12(h)(ii) of the VAT Act.
[75] Clause 12(g) of the Draft Value-added Tax Bill.
[76] VATCOM Report *op cit* 48 – 49.
[77] VATCOM Report *op cit* 50.
[78] VATCOM Report *op cit* 51.

The majority of representations made by interested parties in the pharmaceutical industry and pharmacists held the view that the exemption of medical services should be deleted and all medical services and medicines should be subject to VAT. Such an approach would level the playing fields for all parties supplying medicine in different circumstances and places and would ensure that prescription medicines and other products used for self-medication would be treated equally.[79]

After considering the impact which the proposed exemption of medical services would have, VATCOM proposed that all medical services and medicines be subject to VAT at the standard rate.[80] The VAT Act which was promulgated on 12 June 1991 did not provide for the exemption of (or any other concession for) medical services or medicines. The then Minister of Finance, Mr Barend Du Plessis, reiterated in his Media Statement of 21 August 1991 that the view was held that tax was not a cause of the cost increases experienced with regard to medical services and medicine and tax did not form part of the solution for these increases. It was added that as Government already made substantial contributions in respect of medical care for the underprivileged by way of subsidies, the Government did not see its way clear to make further concessions in this regard.

## Water, electricity and other basic municipal services

No special provision was made for these services in the Draft VAT Bill. However, as the Draft VAT Bill proposed that municipal rates and taxes would be standard rated, all representations to VATCOM merely focussed on this aspect, requesting the exemption of the rates. VATCOM (with one member dissenting) recommended that the proposed standard rating of the rates and taxes be maintained to prevent double taxation and apportionment difficulties for local authorities.[81]

The VAT Act which was promulgated on 12 June 1991 did not provide any relief for local authority services.[82] Due to political pressure, an amendment was introduced on 17 July 1991, providing for the effective exemption of rates and taxes.[83] The supply of electricity, gas or water, drainage services and sewage or garbage removal or disposal services (i.e. trading services) was however expressly standard rated. While the effective exemption of municipal rates was replaced by a zero-rating with effect from 1 July 2006, the standard rating of electricity, gas or water, drainage services and sewage or garbage removal or disposal services has been maintained.

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[79] VATCOM Report *op cit* 49 – 50.
[80] VATCOM Report *op cit* 51. One member did not agree.
[81] VATCOM Report *op cit* 47 – 48.
[82] All the activities of a local authority were, regarded as the carrying on of an enterprise, see paragraph (b)(ii) of the definition of ‘enterprise’ of the original VAT Act, 1991.
[83] Section 21(b) of the Taxation Laws Amendment Act 136 of 1991 which was promulgated on 17 July 1991.

# Conclusion

When VAT was introduced in South Africa, a policy decision was taken to introduce a broad-based VAT system. The intention was to restrict concessions to a minimum. The needy would be assisted as far as possible outside the tax system.

However, due to pressure from various lobby groups as well as Government's inability to prove that the necessary assistance would in fact be given to the needy to compensate for the effect of VAT, various concessions had to be introduced to ensure the smooth introduction of VAT in South Africa.

The aim of this study is to determine whether the current concessions should be retained and also to ascertain whether the policy considerations which applied when VAT was introduced, are still relevant or whether changed circumstances would justify the introduction of further concessions.

# Chapter 4: Views of stakeholders

# Introduction

The Terms of Reference for this study indicated a need to canvas the views of the proponents of changes to the existing VAT dispensation in respect of merit goods, to assess their arguments and to determine a short list of additional goods and services warranting further consideration. In order to achieve these objectives a process of stakeholder participation was undertaken on the basis outlined in below. The responses received to a questionnaire distributed to the identified stakeholders are summarised in the "Views of stakeholders" section below. This is followed by a preliminary assessment of whether the goods or services proposed warrant further consideration for a more favourable VAT dispensation.

# The process followed

## Basis of selecting stakeholders

The overall purpose of this study is to research, assess and make recommendations regarding the VAT treatment of existing or additional merit goods and services. For this reason stakeholders were identified as being parties that are involved in the production, distribution or consumption of products that constitute merit goods or services and warrant a more favourable VAT treatment – either on the basis of international precedent or because of submissions made to the tax authorities since VAT was introduced in South Africa. The identification of stakeholders whose views were to be canvassed as part of this study was undertaken with the guidance of the study's Steering Committee.

**Table 25: List of stakeholders**

| Organisation | Basis for stakeholder status | Approach in terms of | |
|---|---|---|---|
| | | Existing merit good or service | Proposed new merit good or service |
| Congress of SA Trade Unions | Consumers of existing and proposed merit products | ▲ | ■ |
| Law Society of South Africa | Legal implications of changed status | ▲ | ■ |
| BUSA/SACOB | Suppliers of products. Vendors. Compliance with VAT system | ▲ | ■ |
| SAICA | Administration of, and compliance with, VAT system | ▲ | ■ |
| National Consumer Forum | Representation of consumers | | ■ |
| SA National Consumer Union | Representation of consumers | ▲ | ■ |
| SARS | Administration and revenue collection | ▲ | ■ |
| Fiscal Incidence Study Unit | Prior research conducted into tax incidence | ▲ | ■ |
| Department of Social Development | Social development and poverty alleviation | ▲ | ■ |
| Consumer Goods Council of South Africa | Suppliers of consumer goods | ▲ | ■ |
| | | | |
| Magazine Publishers Association of Southern Africa | Suppliers of reading material | | ■ |
| Newspaper Association of Southern Africa | Suppliers of reading material | | ■ |
| Juta / or LexisNexis | Suppliers of reading material | | ■ |
| Publisher's Association of South Africa | Suppliers of reading material | | ■ |
| Publishing Industry Cluster Council | Suppliers of reading material | | ■ |
| | | | |
| Independent Schools Association of Southern Africa | Suppliers of education goods and services | ▲ | ■ |
| Damelin | Suppliers of education goods and services | ▲ | ■ |
| Council on Higher Education | Suppliers of education goods and services | ▲ | ■ |
| Directorate of Private FET Colleges | Policy co-ordinator of private FET sector | ▲ | ■ |
| Department of Education | Policy co-coordinator/supplier of education goods and services | ▲ | ■ |

| Organisation | Basis for stakeholder status | Approach in terms of | |
|---|---|---|---|
| | | **Existing merit good or service** | **Proposed new merit good or service** |
| | | | |
| Council for Medical Schemes | Funding of medical goods and services | | ■ |
| Health Professions Council of South Africa | Suppliers of medical services | | ■ |
| Netcare | Suppliers of medical services | | ■ |
| South African Medical Association | Suppliers of medical services | | ■ |
| Pharmaceutical Society of South Africa | Suppliers of medicines | | ■ |
| Department of Health | Policy co-ordinator and administrator of health sector | | ■ |
| | | | |
| Transnet / Spoornet | Suppliers of transport services | | ■ |
| SANTACO | Suppliers of transport services | | ■ |
| Department of Transport | Policy co-ordinator and administrator of transport sector | | ■ |
| | | | |
| Department of Agriculture | Policy co-ordinator and administrator of agricultural sector | ▲ | |
| Agri South Africa | Suppliers of agricultural products | ▲ | |
| | | | |
| SALGA (South African Local Government Association) | Suppliers of electricity and water | | ■ |
| NER (National Electricity Regulator) | Regulator of the electricity sector | | ■ |
| IMFO (Institute of Municipal Finance Officers) | Suppliers of electricity and water | | ■ |
| Department of Water Affairs and Forestry | Policy co-ordinator and administrator of water sector | | ■ |
| Department of Minerals and Energy | Policy co-ordinator and administrator of electricity and fuels sector | ▲ | ■ |

## Method of approach

The organisations identified as stakeholders above were then contacted telephonically to determine the name and contact details of the person most suitable to deal with an issue such as the VAT treatment of merit goods. The nominated person was e-mailed a letter of introduction from National Treasury, as well as a copy of the survey questionnaire. Follow up e-mails and telephone calls were then made to encourage responses, and in some cases meetings were requested.

Despite these efforts the number of responses received was limited. Some reasons for the poor response include :

- Stakeholders indicating that they did not wish to respond or that they did not have the capacity to respond.
- Many of the stakeholders who previously requested preferential VAT treatment for a particular product have concluded that it is inappropriate or that there are unlikely to be changes to the status quo.
- The questionnaire indicating that consideration would have to be given to recovering any VAT losses arising from a change in the current VAT treatment of a product from an increase in other taxes.

## Questionnaire

The questionnaire distributed to the identified stakeholders is reproduced below.

## QUESTIONNAIRE ON THE VAT TREATMENT OF MERIT GOODS

**Introduction and purpose:**

The National Treasury has appointed PricewaterhouseCoopers to assist with an investigation into the VAT treatment of so-called "merit goods and services". A letter of introduction is attached to this communication that provides the background to the need for such a study.

The purpose of this questionnaire is to ensure stakeholder participation in the study and to obtain their views on the VAT treatment of certain merit goods and services. It is important to bear in mind the fact that VAT is currently the second largest source of government revenue, with personal income tax the main source of revenue. Therefore, any amendments to the VAT system would have to be considered in the light of revenue losses and other economic costs imposed on society.

Stakeholders are only expected to respond to those questions and requests for information that they regard as relevant to their constituency and for which they possess adequate data and insights.

### The nature of the VAT system, and the products receiving differential treatment:

1. Provide a detailed indication of the constituency represented by your organisation.
2. Does your organisation believe that variations in the VAT treatment of different products are an effective means of achieving other social and economic objectives?
3. If the answer to question 2 above is "Yes", which good or service groups warrant consideration for differential VAT treatment?
4. Provide a detailed motivation for the choice of each of the goods or services listed under question 3. Also indicate which particular policy objectives of government are likely to be enhanced due to possible legislative amendments.
5. In the event of equity considerations featuring as part of the motivation in question 4, is your organisation aware of potential alternatives that could be implemented on the expenditure side of the Budget (as opposed to the revenue side)?
6. Does your organisation regard the potential VAT revenue loss of a possible concession as material?

**The nature of the product markets receiving differential treatment**

In relation to each of the product categories your organisation believes should receive differential treatment (outlined in point 3 above), try to provide estimates of the following information:

7. What is the total value added of the good or service? This should equate to the total value of final sales to a consumer in a specific period.
8. How many suppliers of the product are there in South Africa? Distinguish between producers/manufacturers and distributors.
9. What is the estimated market share of the top 5% and top 10% of suppliers?
10. How does your organisation rate the levels of competition within the particular product market?
11. Do you have any information relating to the consumers of the product – such as market research indicating the proportion of sales to different income bands? If so, please provide relevant information.
12. Estimate the administrative and systems compliance costs associated with changing the VAT treatment of the proposed product.
13. Provide any other information that could assist with the consultancy's task of conducting a cost/benefit analyses for each of the proposed products (costs would include issues such as administrative compliance and economic inefficiencies caused by any reallocation of resources that could flow from tax changes).

## List of responses received/obtained

Ultimately, formal responses were obtained from the following organisations:

- Publishers' Association of SA (PASA)
- Print Industries Cluster Council (PICC)
- Department of Education
- Department of Health
- Pharmaceutical Society of South Africa (PSSA)
- Transnet
- Business Unity SA / SACOB
- University of KwaZulu-Natal.

# Views of stakeholders

## Books

It was noted in Chapter 3 that:

> "Representations were made to VATCOM that the supply of books, newspapers, magazines and the services of the electronic media are of an educational nature and should be afforded special treatment such as zero-rating, exemption or lower rates. It was argued that subjecting these goods and services to VAT would amount to a tax on knowledge."

Currently, books are standard rated in terms of VAT. In its submission, the Publishers' Association of SA (PASA) argued that "a tax on books is a tax on knowledge itself and that any tax, of any description, that increases the price of printed, bound books should be resisted by every legal means possible. The implementation of a tax on knowledge is a very real impediment to reading that imposes, in turn, a real restriction upon the nation's freedom to read that, in its turn, impedes the creative output and the free dissemination of ideas and works by writers from our own country and abroad".

Not all participants in the printing and publishing and education sectors however, are in agreement with this view and some believe that zero-rating of books is not necessarily the most effective way of addressing this issue. The Print Industries Cluster Council (PICC) highlights significant structural constraints within the print industry and does not believe that zero-rating will address them. It could, in fact delay the adoption of meaningful changes. PICC and the National Department of Education argue that an increase in funding ring-fenced to libraries and education institutions would have a greater impact on reading and literacy levels. The National Department of Education says that access to books in mother tongue is essential and that providing books to primary schools will have a greater impact on literacy levels (and ultimately on the quantity of books read and purchased in South Africa) than the zero-rating of books.

The Department estimates that the cost of providing 100 books each to 75 000 classrooms (grades 1 to 3) would be around R750 million. Such purchases would constitute a significant fillip to the local printing and publishing industry, since book trade is currently valued at around R2.2 billion. The top 5 publishers account for about 70% of turnover.

## Educational services

At present, educational services are exempt from VAT. However, one stakeholder believes that education is most deserving of a change in its VAT status since the current exemption prevents institutions recovering VAT on certain purchases. As many educational institutions are already struggling financially, the zero-rating of educational services would assist them by allowing them to recoup VAT paid on their purchases.

However, the Department of Education does not believe there is substantial justification for changing the current status since the bulk of educational services provided to lower income groups are supplied by state-funded institutions. Zero-rating would really have cash-flow implications for the fiscus, rather than providing real savings.

## Medicines

At the time when VAT was first introduced in South Africa, there was some difference of opinion amongst the medical and pharmaceutical fraternity about the most appropriate treatment of medicines. It is noted in Chapter 3 above that at that time:

> "The majority of representations made by interested parties in the pharmaceutical industry and pharmacists held the view that the exemption of medical services should be deleted and all medical services and medicines should be subject to VAT. Such an approach would level the playing fields for all parties supplying medicine in different circumstances and places and would ensure that prescription medicines and other products used for self-medication would be treated equally."

Medicines are currently standard rated. However, the Pharmaceutical Society of South Africa (PSSA), which represents 4 576 pharmacists in all sectors of pharmacy, recommends that all registered medicines should be zero-rated. They argue that limiting preferential treatment only to registered medicines would ensure that benefits only accrue to products that have been certified safe and effective. Registered medicines are clearly defined and identifiable and their zero-rating would act as an incentive to non-registered producers to register their products. The zero-rating of registered medicine is in line with government policies on healthcare and the costs of medicines and would be consistent with other attempts by the National Department of Health to reduce the cost of medicines. The PSSA argues that lowering medicine prices would reduce reliance on the public health system and increase direct access to medicine that could arguably control the prevalence of communicable diseases such as tuberculosis. Current VAT on private market sales is estimated at R1.8 billion.

The top 20 manufacturers of medicines account for 66% of the market, whilst the top 50 account for 93% of the private market. The dramatic growth in the generic medicine market is increasing competition levels, which are perceived to be high.

## Merit goods and services in general

Business Unity South Africa (BUSA) is an umbrella organisation for representative businesses organisations that are both multi-sectoral and industry-specific. Of these members, 13 of the 14 respondents were in full support of the view that VAT should be non-discretionary and should include all goods and services traded in the economy. They do not believe that tax exemptions or zero-rating are effective instruments for assisting the poor and are strongly opposed to the adoption of multiple VAT rates (in addition to existing standard, exempt and zero rates). They further argued that the administration would be burdensome, particularly for small business. There would also be definitional problems.

## Summary of views received

The views received are summarised in Table 26 below:

**Table 26: Summary of views received**

| Good/Service | Organisation | Summary of Views |
|---|---|---|
| Books | Publishers' Association of SA (PASA)<br><br>PASA has 144 members representing an estimated 97% of book trade turnover. | • Cheaper access to books means more people of lower income groups will benefit. Zero-rating of educational books and readers would also provide education departments and libraries with additional funds. This would have a great impact of raising literacy levels<br>• As an alternative, government could increase funding to libraries and education institutions (ring-fenced) for the purchase of books<br>• Book trade valued at R2.2 billion<br>• In the education sector books are purchased by education departments and parents on behalf of learners. With trade books it is estimated that 500,000 readers are high intensity readers. This on a population of 45 million is far too low. VAT reduction could grow readership and open new markets for titles in a diverse range of interests and languages<br>• Top 5 publishers account for 70% of turnover, top 10 for 90%<br>• Competition levels believed to be fierce. |
| | Print Industries Cluster Council (PICC) | • Significant structural constraints within the print industry<br>• Doubtful that zero-rating of books would address these constraints in a meaningful way. Could delay the adoption of meaningful changes<br>• Study on the cost of books was commissioned. It also expressed doubts about the effectiveness of zero-rating. |
| | National Department of Education | • Important for Government to send consistent signals that literacy and education are important. Zero-rating could have symbolic importance but it is unlikely to have lasting impact because VAT impact is essentially hidden<br>• Focus on building literacy has to be on first 3 years of schooling. Access to good books in mother tongue essential in these |

| Good/Service | Organisation | Summary of Views |
|---|---|---|
| | | years. Many primary schools do not have resources to purchase books. (Cost estimated at R750 million to get 100 books into each of 75 000 classrooms)<br>• Remaining grades (4 to 12) require 7 textbooks per pupil (9 million learners at R700/learner equals R6.3 billion)<br>• Additional ring-fenced funding preferable to VAT zero-rating at this stage. |
| Medicines | Pharmaceutical Society of South Africa (PSSA)<br><br>PSSA has 4576 members | • Believes that essential services and products should be zero-rated<br>• Proposed that all registered medicines should be zero-rated<br>• Believes that medicines are a basic need. Market does not follow normal market principals because product is not a voluntary purchase<br>• Registered medicines are clearly defined and identifiable. Zero-rating registered medicines would act as an incentive for non-registered medicines to register<br>• Zero-rating would be consistent with other government policies in relation to healthcare and the costs of medicines<br>• Current VAT on private market sales estimated at R1.8 billion<br>• Top 10 manufacturers account for 44% of market. Top 20 for 66% and top 50 for 93% of total private market<br>• Competition levels perceived to be high – especially with development of generic market<br>• Administrative costs of a change not expected to be “dramatic”. Implications for state “sales” limited. |

| Good/Service | Organisation | Summary of Views |
|---|---|---|
| | National Department of Health | • Many essential medicines are paid for through insurance via medical schemes, or provided free by the state.<br>• Medical scheme members pay VAT indirectly through their contributions, but they are typically from the higher income categories.<br>• In 2005 the value of medicine purchases funded by medical schemes amounted to R6.7 billion – with a VAT value equivalent to around R942 million.<br>• "Out-of-pocket" purchases of essential medicines may be significant, but are available at limited cost through public health care facilities.<br>• Because of this the Department does not regard VAT on medicines as problematic from an equity perspective.<br>• Any inequity in access to relation to "out-of-pocket" purchases of medicines are best addressed through government interventions aimed at maximising insurance cover, or the provision of free services.<br>• Although previously largely unresponsive to conventional supply and demand signals, prices have now settled at equilibrium levels due to the single exit price mechanism introduced. Products with generic substitutes are likely to face increased price competition over time – which should health to contain medicine inflation.<br>• New products with no generic competition are generally insensitive to market signals, and it is unlikely that consumers would benefit significantly (if at all) from changes to their VAT treatment. |

| Good/Service | Organisation | Summary of Views |
|---|---|---|
| Education (Schools and tertiary institutions) | Transnet | • Believes that goods/services most deserving of changed VAT status is education. Current exemption means VAT paid on many costs incurred cannot be recovered by institutions that are already struggling financially<br>• Does not believe that revenue loss would be significant |
| | National Department of Education | • Does not believe there is substantial justification for changing current exempt status of education institutions. |
| All | Business Unity SA – An umbrella organisation for organised business[84] | Responses received from membership organisations were overwhelmingly (13 out of 14 organisations) in support of the view below.<br>• VAT should be non-discriminatory and should include all goods and services traded in the economy<br>• Exemptions from the tax and zero-ratings are ineffective instruments for assisting the poor and should (if deemed necessary) be kept to the minimum<br>• The introduction of multiple rates is opposed, for it creates definitional problems, valuation rules and presents burdensome administration requirements on business and small business in particular<br>Dissenting view believes that medicines should have special dispensation. |
| Consumer goods | Consumer Goods Council of SA | Distributed questionnaire to members. No responses received. |

[84] African Mineral and Energy Forum, Agri SA, AHI, Association of Black Securities and Investment Professionals, Automobile Manufacturers Employers Association, Black Business Executive Circle, Black Information Technology Forum, Black Lawyers Association, Black Management Forum, Business Leadership South Africa, Casino Association of South Africa, Chamber of Mines of South Africa, Chemical and Allied Industries Association, Congress of Business and Economics, Insurance Institute of South Africa, Life Offices Association, Master Builders South Africa, National African Farmers Union of South Africa, National African Federated Chamber of Commerce and Industry, National Association of Automobile Manufacturers of South Africa, National Association of Automotive Component and Allied Manufacturers, National Black Business Caucus, National Federation of Building Industries, National Industrial Chamber, Retail Motor Industry, Retailers Association, Road Freight Employers Association, South African Black Technical and Allied Organisation, South African Chamber of Business, South African Communications Forum, South African Federation of Civil Engineering Contractors, South African Institute of Black Property Practitioners, South African Insurance Association, South African Leisure and Tourism Association, South African Petroleum Industry Association, Steel and Engineering Industries Federation of South Africa, The Association for the Advancement of Black Accountants of Southern Africa, The Banking Association South Africa, Business Against Crime

## Assessment of submissions

An assessment of whether the various interests proposing changes to the status quo in respect of the VAT treatment of merit goods and services have a made a good case for a different VAT dispensation must take account of aspects such as:

- Does the product being proposed have the characteristics needed for it to be regarded as a merit good or service?
- Can the good or service be adequately defined, so as to limit damage to the integrity of the VAT system and the "loss" to the fiscus, and provide certainty to the markets?
- Has consideration been given to different ways of achieving the same objective?
- Has an alternative source of tax revenue been identified to compensate the fiscus for any loss in VAT revenue?
- Will the benefits of a different dispensation flow to the intended beneficiaries?
- How significant are the administrative and compliance costs associated with a change to the current dispensation?

Generally, these were questions which the survey questionnaire sought answers to. However, the respondents were often unable to adequately address some of these issues.

As an illustration, while a fairly strong argument can be made that books are closely linked to education and knowledge acquisition, and that they therefore deserve merit status, defining what "books" would qualify is challenging. Would any special dispensation cover all books, or only "educational" books? If it were to apply only to "educational" books, who would determine which books are educational, and on what basis? Would the merit status only apply to books, or also be extended to magazines and newspapers? Would it apply only to hard copy versions, or extend to digital and audio versions? And if not, how would such discrimination be justified in the context of modern trends and technological progress?

The following table summarises the extent to which the submissions arguing for merit status addressed the critical issues outlined above:

**Table 27: Extent to which submissions addressed key issues**

| Key Issue | Proposed Merit Good or Service | | |
|---|---|---|---|
| | Books | Medicines | Educational Services |
| Characteristics of a merit good or service | ✓ | ✓ | ✓ |
| International precedent | ✓ | ✓ | ✓ |
| Product definition | ✓ | ✓ | ✗ |
| Alternative to change in VAT status | ✓ | ✗ | ✗ |
| Alternative source of revenue | ✗ | ✗ | ✗ |
| Information relating to market structure aimed at determining who will benefit from a change | ✓ | ✗ | ✗ |
| Quantification of compliance costs | ✗ | ✗ | ✗ |

In addition to the above product-specific responses, the following general views were discerned from the submissions received:

## Changes to existing zero-rated status

No submissions were received that proposed that existing zero-rated products should be standard rated. While the BUSA response argues that exemptions and zero-ratings are ineffective methods of assisting the poor and should be kept to a minimum, it does not go so far as to propose that there should be a change to the VAT status of goods and services that are currently zero-rated.

## Exemption versus zero-rating

There is a clear preference for zero-rating over exemption. Most parties recognise that exempt status provides limited benefit, and imposes additional administration and compliance costs on the parties that supply the product concerned. It will be noted from the economic analysis in Chapter 5 that the existing exempt status of the goods considered in this study translates into effective VAT rates of around half the current standard rate.

## Multiple rates

There is a limited appreciation of the fact that South Africa already has multiple rates of VAT. Currently, VAT may be charged at the standard rate (14%), a zero rate, and varying effective rates on exempt products that differ according to the ratio of the value added at the final stage of supply to the final selling price[85]. None of the

[85] On the basis of an analysis of supply and use tables, the exempt products that form part of this study yielded effective VAT rates of between 7% and 8%.

respondents favoured the introduction of additional rates over and above those already in place.

### Implications of mixed supply

According to some tax practitioners and consultants the administrative and accounting implications of mixed supply are not generally well understood by commerce and industry in South Africa. Vendors engaged in the supply of both standard rated and exempt products are required to apportion their input costs on some appropriate and defendable basis, so that they only claim input tax on the costs of supply directly related to the standard or zero rated products. But it appears that many vendors engaged in such "mixed supply" find it difficult to adopt appropriate bases for the apportionment of costs. The administrative complexity and compliance costs associated with mixed supply probably provide a partial explanation for the general rejection of the introduction of additional rates, and the preference for zero-rating over exemption.

### Alternative sources of tax revenue

None of the submissions received were prepared to offer suggestions for alternative forms or sources of tax to compensate for any VAT losses arising from a proposed change to the present dispensation.

### Compliance costs

None of the submissions received were either willing or able to quantify the administrative and compliance costs associated with implementing a change to the current VAT dispensation for a specific product. However, the Publishers' Association did indicate that the administrative costs of a change in the VAT treatment of books would not be significant <u>if</u> books were zero-rated for VAT purposes. The Pharmaceutical Society had a similar view.

## Conclusions

While an international precedent exists for concessionary VAT treatment of all the existing and proposed merit goods and services, there appears to be relatively little in the way of new arguments to support the claim of merit good status from those that were considered by VATCOM when VAT was first introduced in South Africa. At the same time, while none of the submissions received responded to the complete range of issues addressed in the questionnaire, there was nothing in the arguments that they contained that would lead to their automatic exclusion from further consideration.

Those stakeholders requesting a favourable VAT dispensation did not consider any option other than zero-rating, and believed that any costs associated with a change from the current dispensation would be minimal – provided that the change was towards zero-rating. This suggests that there is recognition of the fact that exemption is cumbersome and costly to administer.

Stakeholders advocating concessionary VAT treatment for medicines and books did provide reasonably plausible and practical suggestions for the definition of the products that would be accorded the favourable status. In the case of medicines, it was proposed that any concession should be limited only to registered medicines, while in the case of books benefits would only apply to books with allocated ISBNs. However, in the latter case, this definition could be criticised for discriminating against digital and audio versions of the same text, and for ignoring other printed material – such as newspapers and magazines - that may arguably constitute the most widespread and accessible forms of reading matter for the masses.

It is also possible that the requests for merit good status, and the definitions proposed, would achieve a secondary objective of providing barriers to entry or other competitive advantages for their proponents. In the case of medicines, the proposed limitation of any concession to registered medicines could serve to reduce competition from unregistered medicines, while in the case of books, limiting preferential treatment to printed books with ISBNs would afford some advantage over digital material.

# Chapter 5: Economic impact assessment

## Introduction

It is clear from the analysis of international trends and practice in Chapter 2 that there is some precedent for affording merit goods and services some form of favourable VAT treatment. But the mere fact that other countries choose to treat certain products differently does not, by itself, mean that South Africa should follow suit, especially when the adoption of such preferential treatment is in conflict with sound tax principles. The fundamental considerations in any decision to change the existing dispensation must be:

- whether there are sound and logical arguments for doing so; and
- whether such changes would achieve their stated objectives.

For this reason, the Terms of Reference indicated a need to assess the economic consequences of both existing and proposed exceptions. Ultimately, the purpose of the empirical analysis contained in this chapter, and in Chapters 6 and 7, is to determine whether in fact products that are currently zero-rated with the objective of reducing the perceived regressivity of VAT do, in fact, succeed in making the VAT system less regressive; whether the adoption of a more favourable VAT dispensation will lead to a noteworthy reduction in the price paid by consumers, and thereby promote increased consumption of that product; and whether differential treatment does, in fact, reduce the administrative and compliance burden associated with "hard-to-tax" products such as financial services and public – particularly taxi commuter - transport.

## Exclusion as an instrument of addressing regressivity

It was noted in Chapter 2 that:

> "VAT concessions will normally reduce regressivity of the VAT system, if the expenditure patterns of the poor are viewed in isolation. In this regard, a zero-rating would normally be the most effective form of concession. The relative effectiveness of an exemption or lower VAT rate would depend on the pricing structure and ratio of investment/overheads to labour. VAT concessions that cannot be targeted to apply only to the poor and needy, will distort equity in the economy, as the affluent will also benefit there from, thus worsening the perceived regressivity of the VAT system. This will also affect the total revenue collected under the VAT, which might ultimately result in an increase in the VAT rate."

## Analysis of household spending

In order to assess the relative impact of existing and proposed variations in VAT concessions, an analysis of household spending patterns was undertaken. Expenditure weights determined from the 2000 Household Income and Expenditure Survey conducted by Statistics South Africa were applied to household expenditure figures for 2006 published by the South African Reserve Bank. The analysis was disaggregated into five expenditure groups – titled “Very Low”, “Low”, “Middle”, “High” and “Very High”. Each expenditure group represents roughly 20% of South African households, with the “Very Low” expenditure group representing households with estimated annual expenditure in 2000 of less than R8 071; the “Low” expenditure group accounting for households with expenditure of between R8 071 and R12 264; the “Middle” expenditure group representing households with expenditure between R12 264 and R24 366; the “High” expenditure group incorporating households with annual expenditure in 2000 of between R24 366 and R55 160; and the “Very High” expenditure group representing households with more than R55 160 of expenditure. According to the survey sample, the average annual expenditures in 2000 associated with each expenditure group was R5 314, R10 052, R17 340, R35 707 and R139 243 respectively.

A review of existing zero-rated and exempt products confirms the validity of the view that preferential VAT treatment will only assist in reducing regressivity if the spending patterns of lower income households are viewed in isolation. Table 28 below indicates that a number of these goods do carry a proportionately higher weight in the spending patterns of lower income groups.[86]

[86] Total annual spending on the product by the group is expressed as a percentage of total annual expenditure by the group.

**Table 28: Spending weights of products currently zero-rated or exempt expressed as a percentage of the total expenditure of that group**

| Product | Expenditure Group | | | | |
|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High |
| Zero-rated products | | | | | |
| Mealie meal | 7.08% | 5.44% | 3.04% | 1.12% | 0.24% |
| Bread flour # | 1.15% | 0.94% | 0.51% | 0.18% | 0.04% |
| Rice | 1.69% | 1.68% | 1.26% | 0.71% | 0.21% |
| Mealie rice | 0.66% | 0.59% | 0.36% | 0.17% | 0.05% |
| Brown bread | 3.00% | 3.14% | 2.57% | 1.41% | 0.35% |
| Cooking oils | 1.43% | 1.37% | 1.43% | 1.31% | 0.59% |
| Fresh milk | 0.89% | 0.95% | 0.96% | 0.81% | 0.44% |
| Sour milk | 0.30% | 0.29% | 0.23% | 0.14% | 0.04% |
| Milk powder | 0.45% | 0.48% | 0.40% | 0.22% | 0.05% |
| UHT milk | 0.26% | 0.22% | 0.16% | 0.13% | 0.08% |
| Eggs | 0.92% | 0.96% | 0.85% | 0.54% | 0.20% |
| Potatoes | 1.90% | 1.44% | 0.99% | 0.59% | 0.17% |
| Mealies | 0.19% | 0.12% | 0.05% | 0.02% | 0.02% |
| Tomatoes | 0.92% | 0.82% | 0.62% | 0.36% | 0.12% |
| Lettuce | 0.01% | 0.01% | 0.02% | 0.04% | 0.05% |
| Apples | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Bananas | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Oranges | 0.02% | 0.02% | 0.05% | 0.08% | 0.06% |
| Paraffin | 0.04% | 0.05% | 0.05% | 0.04% | 0.02% |
| Exempt products | | | | | |
| Pubic transport – buses | 0.00% | 0.00% | 0.00% | 0.00% | 0.01% |
| Public transport – trains | 0.00% | 0.00% | 0.02% | 0.06% | 0.12% |
| Public transport – metered cab | 0.00% | 0.00% | 0.01% | 0.02% | 0.07% |
| Public transport – other | 0.00% | 0.00% | 0.00% | 0.00% | 0.02% |
| Education pre-primary | 0.04% | 0.08% | 0.16% | 0.35% | 0.53% |
| Education: public schools | 0.01% | 0.02% | 0.04% | 0.08% | 0.09% |
| Education: private schools | 0.00% | 0.00% | 0.00% | 0.01% | 0.04% |
| Teachers training colleges | 0.00% | 0.00% | 0.00% | 0.00% | 0.01% |
| Universities | 0.04% | 0.10% | 0.13% | 0.21% | 0.15% |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB*

*# Only "brown wheaten meal" is actually zero-rated. However, the available figures do not allow such an analysis – so the figure for bread flour has been used. It is estimated that only 5 – 10% of all retail flour sales are for brown wheaten meal.*

The surprisingly low shares of expenditure on certain product categories such as public commuter transport, and some foodstuffs by the "Very Low" and "Low" expenditure groups - which sometimes only register at the level of the third or forth decimal point – may be explained by the fact that:

- Households in these expenditure categories are predominantly located in rural areas where they seldom have access to, or need to use, public commuter transport.
- They consume certain foodstuffs (such as apples and bananas) at a subsistence level, which is not captured by the Income and Expenditure

Survey. Otherwise they do not have access to these foodstuffs, and they therefore do not form part of their diet.

- Their income levels are simply too low for them to access these products.

Once account is taken of the shares of total spending of each expenditure group, and the spending weights are adjusted accordingly,[87] (see Table 29 below) it becomes apparent that there are few products where the absolute spending by lower expenditure groups on that product is higher than that undertaken by higher income groups.

[87] To reflect spending by the group on a product as a percentage of total household consumption spending.

**Table 29: Spending weights of products currently zero-rated or exempt expressed as a percentage of the total household expenditure by all groups**

| Product | Expenditure Group | | | | |
|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High |
| Zero-rated products | | | | | |
| Mealie meal | 0.25% | 0.27% | 0.40% | 0.23% | 0.14% |
| Bread flour # | 0.04% | 0.05% | 0.07% | 0.04% | 0.02% |
| Rice | 0.06% | 0.08% | 0.17% | 0.15% | 0.12% |
| Mealie rice | 0.02% | 0.03% | 0.05% | 0.03% | 0.03% |
| Brown bread | 0.11% | 0.16% | 0.34% | 0.29% | 0.20% |
| Cooking oils | 0.05% | 0.07% | 0.19% | 0.27% | 0.34% |
| Fresh milk | 0.03% | 0.05% | 0.13% | 0.17% | 0.26% |
| Sour milk | 0.01% | 0.01% | 0.03% | 0.03% | 0.02% |
| Milk powder | 0.02% | 0.02% | 0.05% | 0.04% | 0.03% |
| UHT milk | 0.01% | 0.01% | 0.02% | 0.03% | 0.05% |
| Eggs | 0.03% | 0.05% | 0.11% | 0.11% | 0.12% |
| Potatoes | 0.07% | 0.07% | 0.13% | 0.12% | 0.10% |
| Mealies | 0.01% | 0.01% | 0.01% | 0.00% | 0.01% |
| Tomatoes | 0.03% | 0.04% | 0.08% | 0.07% | 0.07% |
| Lettuce | 0.00% | 0.00% | 0.00% | 0.01% | 0.03% |
| Apples | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Bananas | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Oranges | 0.00% | 0.00% | 0.01% | 0.02% | 0.04% |
| Paraffin | 0.00% | 0.00% | 0.01% | 0.01% | 0.01% |
| Exempt products | | | | | |
| Pubic transport – buses | 0.00% | 0.00% | 0.00% | 0.00% | 0.01% |
| Public transport – trains | 0.00% | 0.00% | 0.00% | 0.01% | 0.07% |
| Public transport – metered cab | 0.00% | 0.00% | 0.00% | 0.00% | 0.04% |
| Public transport – other | 0.00% | 0.00% | 0.00% | 0.00% | 0.01% |
| Education pre-primary | 0.00% | 0.00% | 0.02% | 0.07% | 0.31% |
| Education: public schools | 0.00% | 0.00% | 0.01% | 0.02% | 0.05% |
| Education: private schools | 0.00% | 0.00% | 0.00% | 0.00% | 0.02% |
| Teachers training colleges | 0.00% | 0.00% | 0.00% | 0.00% | 0.01% |
| Universities | 0.00% | 0.01% | 0.02% | 0.04% | 0.09% |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB*

*# Only "brown wheaten meal" is actually zero-rated. However, the available figures do not allow such an analysis – so the figure for bread flour has been used. It is estimated that only 5 – 10% of all retail flour sales are for brown wheaten meal.*

## Comparing VAT "savings" by income group

### *Value of current zero-ratings and exemptions*

When the weights indicated in Table 29 were applied to the 2006 final consumption expenditure by households figure published by the South African Reserve Bank, and the resulting VAT 'savings' were calculated, the results are as shown in Table 30 below:

**Table 30: VAT 'savings' accruing to different expenditure groups in 2006 as a result of zero-rating and exemption**

| Product | Expenditure Group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low (Rm) | Low (Rm) | Middle (Rm) | High (Rm) | Very High (Rm) | Total (Rm) |
| Zero-rated products | | | | | | |
| Mealie meal | 383.6 | 414.7 | 607.6 | 347.6 | 206.9 | 1960.3 |
| Bread flour # | 62.1 | 72.0 | 101.8 | 57.1 | 31.5 | 324.5 |
| Rice | 91.5 | 128.3 | 253.0 | 220.1 | 180.0 | 873.0 |
| Mealie rice | 36.0 | 44.7 | 72.5 | 52.1 | 39.8 | 244.9 |
| Brown bread | 162.7 | 239.2 | 515.2 | 435.5 | 308.8 | 1661.4 |
| Cooking oils | 77.7 | 104.1 | 286.6 | 404.2 | 516.5 | 1389.0 |
| Fresh milk | 48.1 | 72.2 | 192.3 | 251.7 | 385.9 | 950.1 |
| Sour milk | 16.4 | 22.0 | 46.1 | 42.3 | 31.7 | 158.6 |
| Milk powder | 24.4 | 36.9 | 79.8 | 66.6 | 47.4 | 255.1 |
| UHT milk | 13.9 | 17.0 | 32.5 | 39.4 | 68.7 | 171.5 |
| Eggs | 50.1 | 73.4 | 169.7 | 165.7 | 178.2 | 637.0 |
| Potatoes | 103.0 | 109.8 | 197.7 | 183.2 | 148.1 | 741.9 |
| Mealies | 10.2 | 9.0 | 9.4 | 6.1 | 14.3 | 49.0 |
| Tomatoes | 49.9 | 62.7 | 125.0 | 112.6 | 108.0 | 458.1 |
| Lettuce | 0.4 | 1.0 | 4.4 | 13.3 | 43.8 | 62.9 |
| Apples | 0.0 | 0.1 | 0.4 | 1.1 | 2.9 | 4.6 |
| Bananas | 0.0 | 0.1 | 0.2 | 0.4 | 1.0 | 1.9 |
| Oranges | 0.9 | 1.9 | 9.4 | 26.1 | 53.9 | 92.3 |
| Paraffin | 2.1 | 3.4 | 9.5 | 12.1 | 18.9 | 46.0 |
| **TOTAL – ZERO-RATED** | **1133.2** | **1412.4** | **2713.1** | **2437.1** | **2386.3** | **10082.1** |
| Exempt products | | | | | | |
| Pubic transport – buses | 0.0 | 0.1 | 1.6 | 7.9 | 48.3 | 57.9 |
| Public transport – trains | 0.1 | 0.0 | 0.8 | 3.0 | 26.9 | 30.8 |
| Public transport – metered cab | 0.0 | 0.0 | 0.0 | 0.1 | 8.1 | 8.2 |
| Public transport – other | 1.1 | 3.2 | 15.9 | 53.9 | 232.4 | 306.6 |
| Education pre-primary | 0.2 | 0.8 | 4.0 | 12.6 | 37.7 | 55.4 |
| Education: public schools | 0.0 | 0.0 | 0.0 | 0.8 | 15.6 | 16.5 |
| Education: private schools | 0.0 | 0.1 | 0.2 | 0.6 | 5.7 | 6.7 |
| Teachers training colleges | 1.0 | 3.9 | 13.4 | 32.1 | 66.6 | 117.0 |
| Universities | 0.0 | 0.1 | 1.6 | 7.9 | 48.3 | 57.9 |
| **TOTAL - EXEMPT** | **2.4** | **8.1** | **36.0** | **111.7** | **445.6** | **603.7** |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB*

*# Only "brown wheaten meal" is actually zero-rated. However, the available figures do not allow such an analysis – so the figure for bread flour has been used. It is estimated that only 5 – 10% of all retail flour sales are for brown wheaten meal.*

It should be noted that the above figures reflect the estimated VAT component of final household consumption expenditure on the products listed in 2006 – assuming that household spending patterns are consistent with the 2000 Income and Expenditure Survey. They do not take account of the income and substitution effects that would arise if the VAT status of a product were to change.

### *Distribution of VAT savings for existing zero-rated and exempt products*

Contrasting the absolute savings of the "Very Low" and "Low" expenditure groups with those accruing to the "High" and "Very High" expenditure groups provides some indication of the effectiveness of zero-rating and exemption as a tool for addressing the perceived regressivity of VAT. Table 31 indicates the proportion of VAT savings accruing to each expenditure group in relation to particular zero-rated and exempt products. In other words, the "savings" shown in Table 30 above are expressed as a percentage of the total savings associated with VAT concessions on the products studied.

**Table 31: Share of VAT savings accruing to different expenditure groups in 2006 in relation to some existing zero-ratings and exemptions**

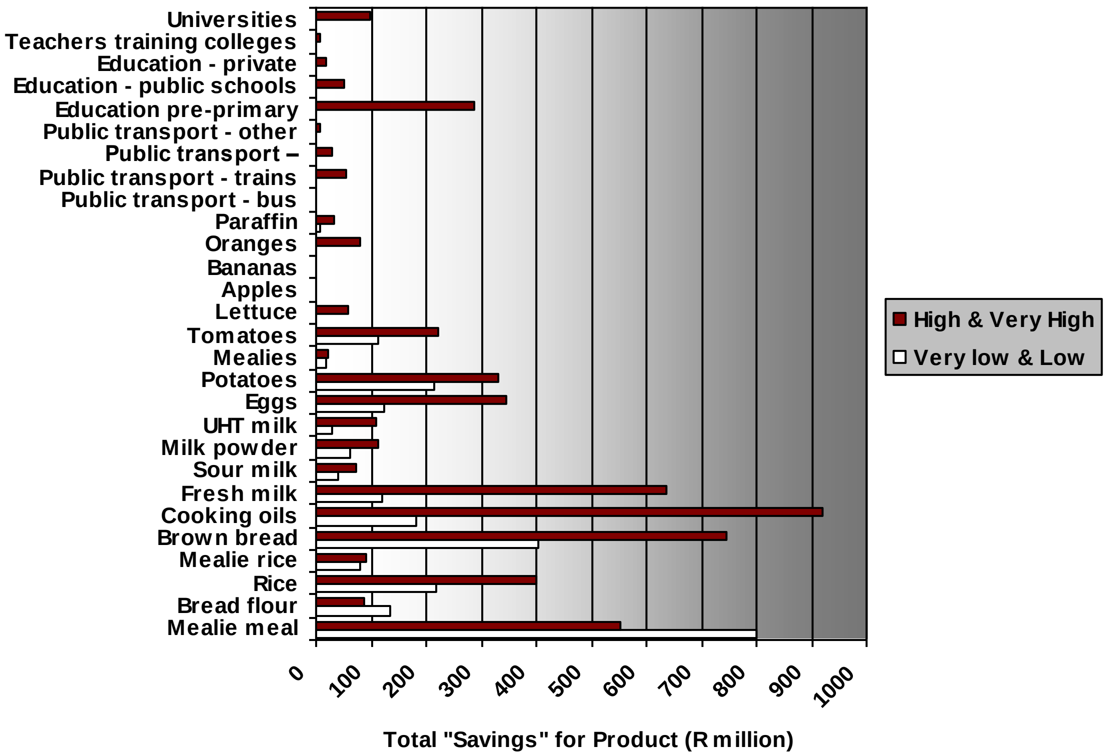
| Product | Expenditure Group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High | Total |
| Zero-rated products | | | | | | |
| Mealie meal | 19.6% | 21.2% | 31.0% | 17.7% | 10.6% | 100.0% |
| Bread flour # | 19.1% | 22.2% | 31.4% | 17.6% | 9.7% | 100.0% |
| Rice | 10.5% | 14.7% | 29.0% | 25.2% | 20.6% | 100.0% |
| Mealie rice | 14.7% | 18.2% | 29.6% | 21.3% | 16.2% | 100.0% |
| Brown bread | 9.8% | 14.4% | 31.0% | 26.2% | 18.6% | 100.0% |
| Cooking oils | 5.6% | 7.5% | 20.6% | 29.1% | 37.2% | 100.0% |
| Fresh milk | 5.1% | 7.6% | 20.2% | 26.5% | 40.6% | 100.0% |
| Sour milk | 10.4% | 13.8% | 29.1% | 26.7% | 20.0% | 100.0% |
| Milk powder | 9.6% | 14.5% | 31.3% | 26.1% | 18.6% | 100.0% |
| UHT milk | 8.1% | 9.9% | 18.9% | 23.0% | 40.0% | 100.0% |
| Eggs | 7.9% | 11.5% | 26.6% | 26.0% | 28.0% | 100.0% |
| Potatoes | 13.9% | 14.8% | 26.7% | 24.7% | 20.0% | 100.0% |
| Mealies | 20.8% | 18.3% | 19.2% | 12.4% | 29.3% | 100.0% |
| Tomatoes | 10.9% | 13.7% | 27.3% | 24.6% | 23.6% | 100.0% |
| Lettuce | 0.7% | 1.6% | 6.9% | 21.1% | 69.6% | 100.0% |
| Apples | 0.3% | 3.0% | 9.5% | 24.1% | 63.1% | 100.0% |
| Bananas | 2.4% | 5.6% | 12.1% | 24.0% | 55.8% | 100.0% |
| Oranges | 1.0% | 2.0% | 10.2% | 28.3% | 58.5% | 100.0% |
| Paraffin | 4.6% | 7.5% | 20.6% | 26.3% | 41.0% | 100.0% |
| Exempt products | | | | | | |
| Pubic transport – buses | 0.0% | 0.0% | 0.3% | 10.7% | 89.0% | 100.0% |
| Public transport – trains | 0.1% | 0.1% | 2.7% | 13.7% | 83.4% | 100.0% |
| Public transport – metered cab | 0.2% | 0.1% | 2.5% | 9.8% | 87.5% | 100.0% |
| Public transport – other | 0.0% | 0.0% | 0.0% | 1.4% | 98.6% | 100.0% |
| Education pre-primary | 0.4% | 1.0% | 5.2% | 17.6% | 75.8% | 100.0% |
| Education: public schools | 0.3% | 1.5% | 7.3% | 22.8% | 68.1% | 100.0% |
| Education: private schools | 0.0% | 0.0% | 0.1% | 5.1% | 94.8% | 100.0% |
| Teachers training colleges | 0.3% | 1.2% | 3.6% | 9.6% | 85.2% | 100.0% |
| Universities | 0.9% | 3.3% | 11.5% | 27.4% | 56.9% | 100.0% |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB*

*# Only "brown wheaten meal" is actually zero-rated. However, the available figures do not allow such an analysis – so the figure for bread flour has been used. It is estimated that only 5 – 10% of all retail flour sales are for brown wheaten meal.*

Figure 2 below indicates that with the exception of mealie meal and bread flour, the savings enjoyed by higher expenditure groups are generally substantially higher than those enjoyed by lower expenditure groups. In absolute terms, the total savings accruing from the products studied to the “High” and “Very High” expenditure groups is estimated to have exceeded that accruing to the “Very Low” and “Low” expenditure groups by almost R2 825 million in 2006. Without taking account of possible income and substitution effects, if the R7.9 billion VAT currently foregone on the products listed was used to finance an increase in, for example, social grants transferred to households, and then such transfers could be increased by about 11%. This equates to a potential increase in social pensions of about R91/month based on pensions paid in the 2006/7 fiscal year.

**Figure 2: VAT savings accruing to different expenditure groups as a result of zero-rating and exemption**




*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000; SARB Quarterly Bulletin. Only “brown wheaten meal” is actually zero-rated. However, the available figures do not allow such an analysis – so the figure for bread flour has been used. It is estimated that only 5 – 10% of all retail flour sales are for brown wheaten meal.*

The conclusion that can be drawn from the above analysis is that existing zero-ratings and exemptions do very little to address the perceived regressivity of the VAT system. On the contrary, they serve to make the VAT system more regressive by transferring substantially more benefits from preferential product treatment to higher expenditure groups than to lower expenditure groups. The only products studied where favourable VAT treatment leads to some reduction in regressivity are mealie meal and bread flour. Since only “brown wheaten meal” is zero-rated, and this is estimated to account for a relatively small proportion of total retail purchases of bread flour, it is doubtful that even this zero-rating assists in reducing regressivity.

### *Distribution of VAT savings in respect of proposed merit goods*

A similar picture emerges from an analysis of products that are currently standard rated for VAT purposes, but which are claimed to warrant merit good status. The percentage distribution of VAT savings amongst different expenditure groups that would be enjoyed if the above products were to be zero-rated is shown in Table 32 below.

**Table 32: Share of VAT paid in 2006 by different expenditure groups on products for which preferential VAT treatment has been requested**

| Product | Expenditure Group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High | Total |
| Currently standard rated | | | | | | |
| Water | 2.8% | 4.3% | 12.7% | 22.4% | 57.8% | 100.0% |
| Electricity | 1.1% | 2.5% | 10.8% | 25.3% | 60.3% | 100.0% |
| Medicine with prescription | 3.5% | 5.9% | 18.9% | 28.6% | 43.1% | 100.0% |
| Health services not covered by medical aid | 1.8% | 4.5% | 14.4% | 22.0% | 57.4% | 100.0% |
| Medicines without prescription | 3.3% | 8.3% | 23.1% | 31.2% | 34.2% | 100.0% |
| Flat fee medical services | 3.6% | 1.8% | 3.6% | 6.9% | 84.1% | 100.0% |
| Doctors, dentists etc | 1.5% | 2.5% | 8.8% | 15.6% | 71.5% | 100.0% |
| Medicines with prescription not covered by medical aid | 0.0% | 0.1% | 1.2% | 9.6% | 89.1% | 100.0% |
| Non medical aid medicines without prescription | 0.2% | 0.2% | 1.4% | 8.3% | 89.9% | 100.0% |
| Textbooks | 0.1% | 1.0% | 8.8% | 25.3% | 64.8% | 100.0% |
| Newspapers | 1.7% | 3.6% | 11.7% | 24.6% | 58.3% | 100.0% |
| Magazines | 9.0% | 8.1% | 23.7% | 32.1% | 27.1% | 100.0% |
| Books | 6.3% | 8.6% | 19.9% | 24.5% | 40.7% | 100.0% |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB*

It is apparent from Table 33 below that when the above shares are applied to estimates of household consumption spending for 2006, once again the “High” and “Very High” expenditure groups would enjoy the bulk of any benefits arising from the zero-rating of these products.

**Table 33: VAT paid in 2006 by different expenditure groups on products for which preferential VAT treatment has been requested**

| Product | Expenditure Group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low (Rm) | Low (Rm) | Middle (Rm) | High (Rm) | Very High (Rm) | Total (Rm) |
| Products currently standard rated | | | | | | |
| Water # | 44.8 | 68.9 | 204.1 | 358.8 | 925.4 | 1602.0 |
| Electricity # | 21.0 | 46.2 | 199.4 | 467.1 | 1113.1 | 1846.7 |
| Medicine with prescription | 1.4 | 2.3 | 7.4 | 11.3 | 17.0 | 39.5 |
| Health services not covered by medical aid | 0.3 | 0.8 | 2.6 | 4.1 | 10.6 | 18.4 |
| Medicines without prescription | 0.1 | 0.4 | 1.0 | 1.3 | 1.5 | 4.3 |
| Flat fee medical services | 0.1 | 0.0 | 0.1 | 0.2 | 1.9 | 2.3 |
| Doctors, dentists etc | 3.1 | 5.3 | 18.6 | 32.8 | 150.1 | 209.8 |
| Medicines with prescription not covered by medical aid | 0.0 | 0.1 | 0.7 | 5.7 | 53.1 | 59.6 |
| Non medical aid medicines without prescription | 0.1 | 0.1 | 0.5 | 3.2 | 34.9 | 38.9 |
| Textbooks | 0.4 | 2.7 | 23.7 | 67.9 | 174.0 | 268.7 |
| Newspapers | 2.5 | 5.2 | 16.6 | 35.1 | 83.0 | 142.4 |
| Magazines | 2.5 | 2.3 | 6.6 | 9.0 | 7.6 | 28.0 |
| Books | 5.9 | 8.1 | 18.7 | 23.0 | 38.2 | 93.8 |
| **Total for these products** | **82.1** | **142.3** | **500.1** | **1019.5** | **2610.5** | **4354.5** |

*Source of basic data: Statistics South Africa, Income and Expenditure Survey: 2000, SARB Quarterly Bulletin*

*# Because these estimates of household spending patterns are derived from the 2000 household income and expenditure survey, the figures do not capture the impact of changes to household subsidies of water and electricity, which were implemented after 2000.*

In aggregate terms, the "High" and "Very High" expenditure groups would have enjoyed direct[88] VAT savings of around R3.6 billion from the zero-rating of the above products (or 80% of total potential savings), while those in the "Very Low" and "Low" expenditure groups would enjoy aggregate direct savings of around R225 million (or 5% of total potential savings).

It is clear from the above that the argument of redressing regressivity through preferential VAT treatment of these products is not valid. However, this does not preclude other arguments being advanced in favour of their status as merit goods and services.

[88] In this context, "direct" refers to the nominal value of VAT "savings" relating only to spending on that product. It does not take account of the economic incidence of changes to the VAT treatment of the products concerned. Also, portions of such savings would almost certainly be spent on other products that are standard rated for VAT purposes, so these figures do not equate to the fiscal gains and losses of such changes. See Chapter 6 for further discussion of this topic.

# Encouraging consumption by facilitating a reduction in price

It was noted in the introduction to this chapter that the arguments in favour of merit good status typically fall into 3 categories. Regressivity was addressed in the preceding section. We now turn our attention to the motive of encouraging consumption of particular goods and services by facilitating a reduction in the market price of the product in question by adopting a preferential VAT treatment.

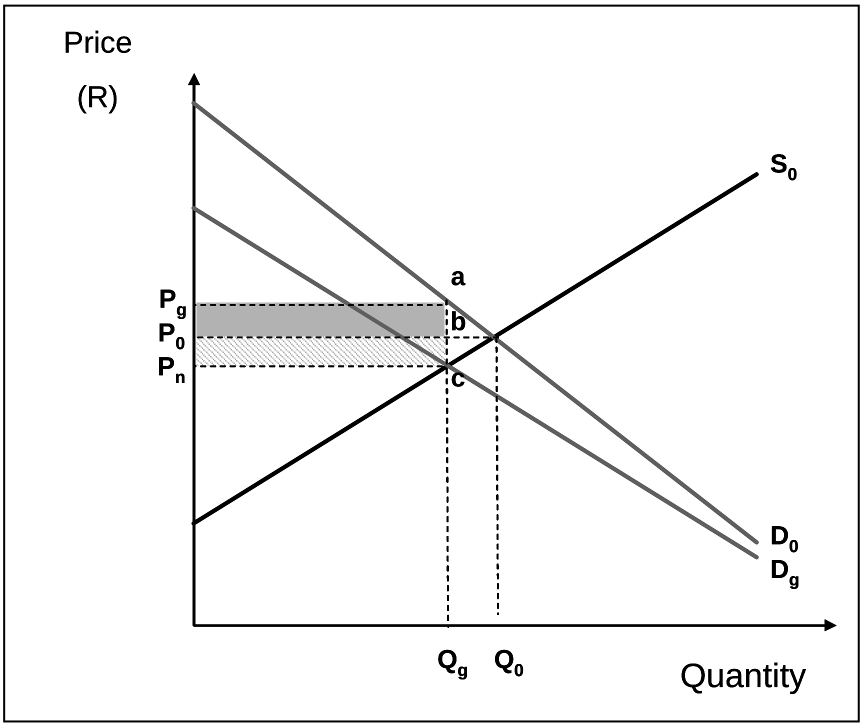
## Tax incidence

In principle, the removal of an *ad valorem* tax such as VAT from a particular product should reduce the equilibrium price of that product in the market and facilitate increased demand for, and consumption of, that product through a combination of price and income effects. In practice, the resulting reduction in price is seldom equal to the amount of tax foregone because, although the intended incidence of the tax might be on consumers, the economic incidence is usually split between consumers and producers/suppliers. To the extent that any price reduction is muted as a result of the economic incidence, any benefits of a movement away from standard rated VAT to a more favourable regime will obviously be reduced.

The theoretical determination of the economic incidence of taxation is illustrated in Figure 3 below. For a given initial supply curve ($S_0$) and demand curve ($D_0$) the equilibrium price and quantity would then be $P_0$ and $Q_0$ respectively. If an *ad valorem* tax equivalent to a 14% VAT was imposed, the demand curve perceived by suppliers of the product would shift from $D_0$ to $D_g$. The total tax collected would be represented by the area $\mathbf{P_g acP_n}$ but the incidence of the tax would be shared with consumers contributing $\mathbf{P_g abP_0}$ and suppliers contributing $\mathbf{P_0 bcP_n}$. If the product was then to be zero-rated, the equilibrium price and quantity could *ceteris paribus* be expected to return to $\mathbf{P_0}$ and $\mathbf{Q_0}$ respectively. However, $\mathbf{P_0}$ is not 14% lower than $\mathbf{P_g}$ (the prevailing price when VAT was levied) and the benefits of the zero-rating do not accrue solely to consumers of the product.

The critical determinant of the extent to which the imposition of a tax (or its removal) is shared arises from the relative price elasticities of supply and demand in the immediate vicinity of the current equilibrium price.

**Figure 3: The economic incidence of taxation**




In practice this means that the ratio in which the economic incidence of taxation is shared between consumers and suppliers of a product is equal to the ratio of the absolute value of the respective gradients of the demand and supply curves. In the illustration above, the gradients are approximately the same – which is why the tax incidence falls almost equally upon both the consumers and the suppliers of the product. If the gradient of a demand curve within the vicinity of the current equilibrium price is twice that of the gradient of the supply curve over that same price range, then two-thirds of the tax incidence will fall on consumers of the product. This would imply that if the tax were to be removed, consumers of the product would receive two-thirds of whatever price reduction the removal of the tax gave rise to. In this context it is possible to state that the basis on which the tax incidence is shared is equal to the ratio of the price elasticities of supply and demand for the product concerned.[89]

In extreme cases where supply is a) perfectly elastic, or b) perfectly inelastic, the tax incidence would either fall completely on the consumer, or completely on the supplier. This implies that in the former case, the consumer would enjoy the full benefit of any subsequent withdrawal of the tax, while in the latter case the producer would be the sole beneficiary of a removal of the tax. These two "extreme cases" are indicated in the Figure 4 below.

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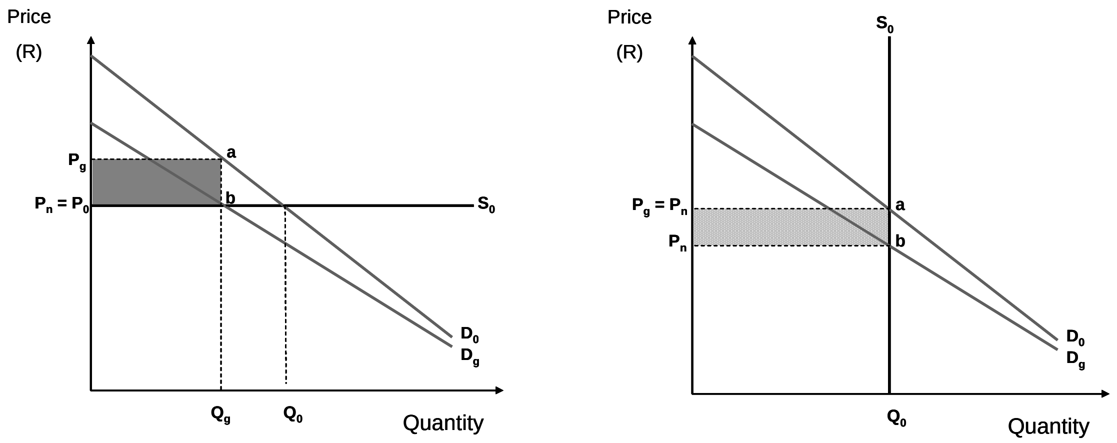
[89] The price elasticity of demand and supply is determined by the formula $E_{D/S} = {}^{P}/_{Q} \times {}^{1}/_{Gradient}$. Since tax incidence is shared according to the ratio of the gradient of the demand function/gradient of the supply function, and P and Q are common to both, the ratio according to which the tax incidence is shared between consumers and producers with be equal to $E_S / E_D$.

**Figure 4: Economic incidence of taxation under extreme supply conditions**




a) Perfectly elastic supply   b) Perfectly inelastic supply

As a general rule we can therefore infer that the more price elastic supply of a product is relative to its demand elasticity, the greater the incidence of a tax will be on consumers. By inference, such a situation would also imply that consumers of the product would benefit to a greater degree if the tax were to be removed. Conversely, the more elastic the demand for a product in relation to its price elasticity of supply, the greater the incidence of the tax would be on suppliers. This would, in turn, imply that they would derive a bigger benefit in the event that the tax was to be removed.

### *Tax incidence in respect of some zero-rated products*

Against this theoretical backdrop, this study obtained estimates of the price elasticities of supply and demand for some[90] of the products that are either already receiving a favourable VAT dispensation, or for which merit good status is being considered.

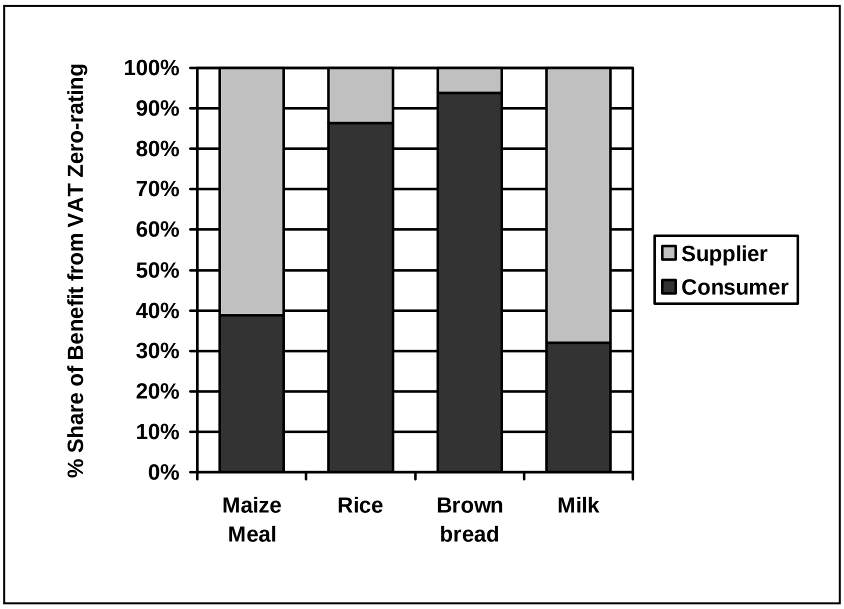
[90] The number of products for which elasticities could be estimated was limited by the availability of suitable data

**Table 34: Elasticities of demand and supply – zero-rated products**

| Existing Zero-rated Products | **Estimated Price Elasticity of Demand** (% decrease in the quantity demanded in response to a 1% increase in price) | **Estimated Price Elasticity of Supply** (% increase in the quantity supplied in response to a 1% increase in price) | **Ratio according to which price savings arising from zero-rating are currently shared between consumers and suppliers** | |
|---|---|---|---|---|
| | | | **Consumers** | **Suppliers** |
| Maize meal | -0.86 | 0.55 | 0.64 | 1 |
| Rice | -0.61 | 3.83 | 6.32 | 1 |
| Brown bread | -0.11 | 1.71 | 15.38 | 1 |
| Fresh Milk | -4.03 | 1.89 | 0.47 | 1 |

With the relative elasticities indicated in the table above it is clear that suppliers of both maize meal and fresh milk benefit to a greater extent from the zero-rating than consumers. By contrast, the bulk of the benefits arising from the VAT zero-ratings on rice and brown bread currently accrue to consumers. On the basis of the ratios according to which the benefits are shared, it could be expected that for every R1 decline in the notional selling price of maize as a result of its zero-rated status, consumers would receive about 39 cents, while suppliers would absorb/retain about 61 cents. In the case of fresh milk, consumers would only receive about 32 cents while suppliers could be expected to absorb around 68 cents. These outcomes are markedly different in the case of rice and brown bread, where consumers enjoy about 86% and 94% respectively of the benefits of zero-rating. These results are summarised in Figure 5 below.

**Figure 5: Proportion of benefits from zero-rating accruing to consumers and suppliers**



### *Tax incidence in the case of proposed merit goods*

In the case of some of the products that are currently standard rated for VAT purposes, but which are being considered for merit good status, the results are as shown in the table below.

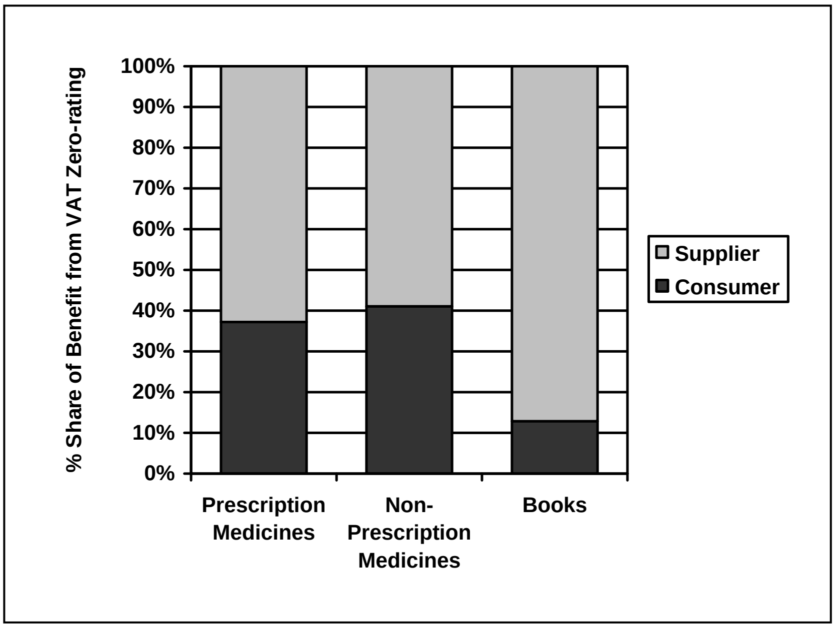
**Table 35: Elasticities of demand and supply – proposed merit goods**

| **Existing Standard rated Products** | **Estimated Price Elasticity of Demand** (% decrease/increase in the quantity demanded in response to a 1% increase in price) | **Estimated Price Elasticity of Supply** (% increase in the quantity supplied in response to a 1% increase in price) | **Ratio according to which price savings arising from zero-rating would be shared between consumers and suppliers** | |
|---|---|---|---|---|
| | | | **Consumers** | **Suppliers** |
| Prescription Medicines | -1.08 | 0.64 | 0.60 | 1 |
| Non-prescription Medicines | -0.92 | 0.64 | 0.70 | 1 |
| Books | -5.91 | 0.87 | 0.15 | 1 |

Figure 6 below indicates the estimated relative proportion of the VAT incidence in the case of medicines and books that falls on consumers and suppliers at present. At present the VAT incidence of books falls predominantly on the suppliers of books, which means that if VAT were to be removed, consumers would gain relatively little. Our estimates indicate that consumers would receive only 13% of any price “saving” arising from the zero-rating of books.

In the case of medicines, the available data allowed us to estimate price elasticities of demand for two categories of medicines, namely prescription, and non-prescription. We assumed that the price elasticities of supply for both categories are similar. It is apparent from Figure 6 that in the case of prescription medicines, the current tax incidence falls 63% on the supplier and 37% on the consumer. This implies that the consumer could be expected to enjoy less than 40% of any “saving” arising from a change to the VAT status of medicines, while the medicine supply chain could be expected to absorb the balance. In the case of non-prescription medicines, the tax incidence is currently shared between suppliers and consumers in the ratio of 59% to 41% respectively. This means that consumers would probably enjoy around 40% of any potential price reduction facilitated by a more favourable VAT treatment.

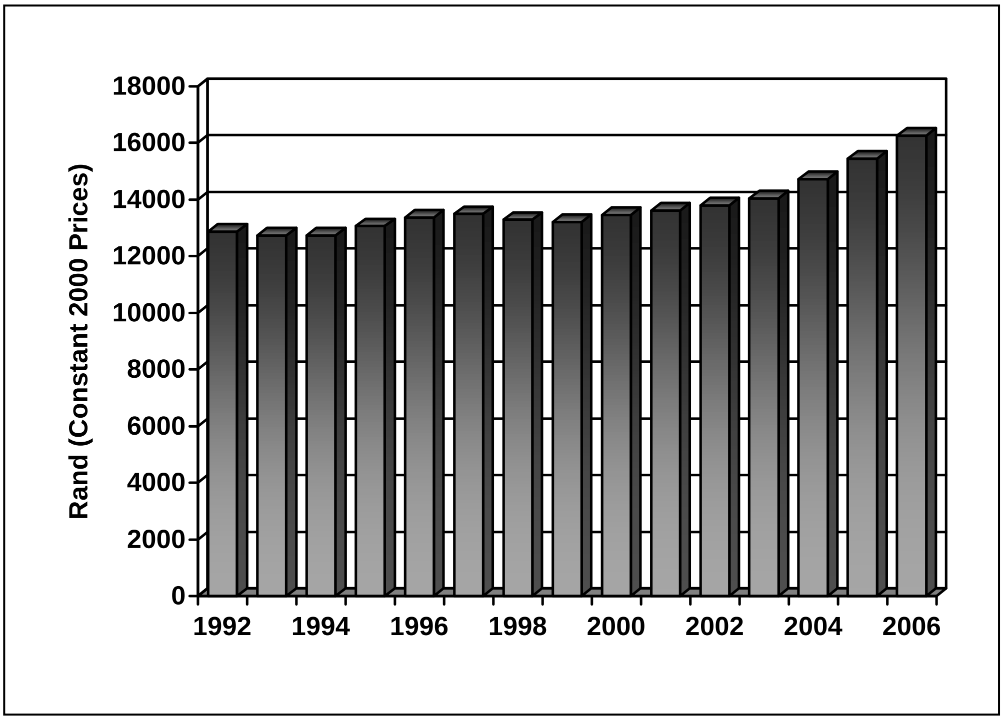
**Figure 6: Proportion of VAT incidence incurred by consumers and suppliers**




## Income elasticities of demand

It was noted in Chapter 1 that the levels of income at the disposal of consumers, and changes in these levels over time, may exercise a greater effect on the quantities demanded of a product than any marginal changes to its price as a result of changes to its VAT treatment. The growth in income over time will be influenced by the levels of efficiency of the economy rather than by changes in the price of specific products. A VAT system that embodies the lowest possible excess burden, and which is the most efficient in generating revenue to fund social and redistributive expenditures will therefore tend to support higher levels of income growth over time. It is apparent from Figure 7 below that the real disposable income per capita has increased steadily since VAT was introduced, and that the rate of increase has accelerated since 2002. The average annual increase in real disposable incomes per capita between 1992 and 2006 was 1.7% per annum, compared with 4.2% per annum between 2002 and 2006. If South Africa was able to achieve the Accelerated Shared Growth Initiative for South Africa (ASGISA) target of an average economic growth rate of 6% per annum, then average real per capita incomes would increase by almost 30% over a five year period.

**Figure 7: Disposable income per capita at constant 2000 prices**




*Source: South African Reserve Bank Quarterly Bulletin*

The estimated income elasticities of some of the products being studied is shown in Table 36 below. The figures reflect the estimated increase in the quantity demanded of a product in response to a 1% increase in the average incomes of that income group. So, for example, a 1% increase in the average incomes of the very low income group would lead to a 1.094% increase in the quantity of maize demanded by that group. Positive income elasticities of around 1 or less suggests that these income groups regard the product as a necessity, while higher elasticities would be associated with luxury products. The results are not surprisingly, the products analysed are largely viewed as necessities.

**Table 36: Estimated income elasticities by expenditure group**

| Product | = Estimated Income/Expenditure elasticities by expenditure group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High | All Groups |
| Mealie meal | 1.094 | 1.061 | 1.071 | 1.069 | 0.916 | 1.047 |
| Brown and whole wheat flour | 0.938 | 1.024 | 1.039 | 1.019 | 0.904 | 1.022 |
| Rice | 0.989 | 0.906 | 1.140 | 0.933 | 0.809 | 1.065 |
| Brown bread | 1.112 | 1.178 | 1.234 | 1.193 | 1.058 | 1.171 |
| Fresh milk | 0.920 | 0.883 | 0.869 | 0.909 | 0.899 | 1.011 |
| Powdered milk | 0.720 | 0.774 | 0.722 | 0.744 | 0.700 | 0.719 |
| Paraffin | 1.027 | 1.074 | 1.061 | 1.063 | 0.889 | 0.922 |
| Eggs | 0.918 | 0.810 | 0.779 | 0.860 | 0.744 | 1.122 |
| UHT milk | 0.556 | 0.444 | 0.438 | 0.583 | 0.622 | 0.591 |
| Sour milk | 0.421 | 0.444 | 0.421 | 0.545 | 0.588 | 0.632 |
| Prescription Medicines | 0.906 | 1.024 | 1.021 | 1.085 | 1.061 | 1.0613 |
| Non-prescription Medicines | 1.094 | 0.976 | 0.979 | 0.912 | 0.597 | 0.9364 |
| Canned fish | 0.896 | 0.804 | 0.833 | 0.889 | 0.791 | 0.843 |
| Books | 0.895 | 1.538 | 0.606 | 1.173 | 1.515 | 0.152 |

If the increases in real disposable incomes per capita are assumed to have been evenly spread across all income groups, and the income elasticities are assumed to have remained relatively stable over time, then the resulting increases in the quantities demanded between 2000 and 2006 for the products listed would have been as indicated in Table 37 below. The extent of these increases is generally greater than the increase in demand resulting from the adoption of a more favourable VAT dispensation, based on the economic incidence analysis conducted above.

**Table 37: Estimated increase in quantity demanded as a result of increases in real incomes between 2000 and 2006**

| Product | Estimated Income/Expenditure elasticities by expenditure group | | | | | |
|---|---|---|---|---|---|---|
| | Very Low | Low | Middle | High | Very High | All Groups |
| Mealie meal | 22.8% | 22.1% | 22.3% | 22.3% | 19.1% | 21.8% |
| Brown and whole wheat flour | 19.6% | 21.4% | 21.7% | 21.3% | 18.9% | 21.3% |
| Rice | 20.6% | 18.9% | 23.8% | 19.5% | 16.9% | 22.2% |
| Brown bread | 23.2% | 24.6% | 25.7% | 24.9% | 22.1% | 24.4% |
| Fresh milk | 19.2% | 18.4% | 18.1% | 19.0% | 18.8% | 21.1% |
| Powdered milk | 15.0% | 16.1% | 15.1% | 15.5% | 14.6% | 15.0% |
| Paraffin | 21.4% | 22.4% | 22.1% | 22.2% | 18.5% | 19.2% |
| Eggs | 19.2% | 16.9% | 16.3% | 17.9% | 15.5% | 23.4% |
| UHT milk | 11.6% | 9.3% | 9.1% | 12.2% | 13.0% | 12.3% |
| Sour milk | 8.8% | 9.3% | 8.8% | 11.4% | 12.3% | 13.2% |
| Prescription medicine | 18.9% | 21.4% | 21.3% | 22.6% | 22.2% | 22.1% |
| Non-prescription medicine | 22.8% | 20.4% | 20.4% | 19.0% | 19.4% | 19.5% |
| Canned fish | 18.7% | 16.8% | 17.4% | 18.5% | 16.5% | 17.6% |
| Books | 18.7% | 32.1% | 12.6% | 24.5% | 31.6% | 3.2% |

*Source of basic data,SA Reserve Bank*

## Market behaviour

The preceding analysis has focussed on who either currently, or prospectively, benefits from a preferential VAT dispensation using a partial equilibrium analysis of tax incidence. However, due to limitations in the available data, (particularly in respect of estimations of supply elasticities), the number of products analysed was limited. However, the likely response of markets to a changed VAT dispensation can also be inferred from their behaviour and structure. For example, if the price increases in products that were zero-rated when VAT was first introduced were consistently higher than non zero-rated substitutes in the years following the introduction of VAT, it could support the conclusion that consumers of those products have gained relatively little from the zero-rating because the supply chain of those products has absorbed the benefits for themselves.

In this context, an analysis of price trends of products that were zero-rated when VAT was introduced, or (in the case of paraffin) were subsequently zero-rated, was undertaken. These trends were then compared with price changes in both non-zero-rated substitutes (where possible) and in the overall consumer basket. Table 38 below indicates the comparative price changes in some existing zero-rated items, some exempt items, as well as some standard rated products that are being considered for merit good status.

**Table 38: Average increases in prices of zero-rated, exempt and standard rated items**

| Product | Average annual increase in prices | | | |
|---|---|---|---|---|
| | 1991 - 1995 | 1996 – 2000 | 2001 - 2005 | 1991 - 2005 |
| Zero-rated Items | | | | |
| Brown Bread | 13.7% | 8.1% | 6.6% | 9.5% |
| Mealie Meal | 9.8% | 4.6% | 3.8% | 6.3% |
| Rice | 8.9% | 6.7% | 2.9% | 5.9% |
| Pilchards | 12.3% | 5.0% | 7.4% | 8.5% |
| Fresh Milk | 5.2% | 8.2% | 9.9% | 8.2% |
| Milk Powder | 12.3% | 11.4% | 8.8% | 10.6% |
| Eggs (Large) | 10.0% | 4.3% | 9.3% | 8.2% |
| Cooking Oil | 5.9% | 5.7% | 11.5% | 7.2% |
| Apples | 7.7% | 7.6% | 5.2% | 6.5% |
| Bananas | 16.3% | -1.2% | 11.7% | 7.5% |
| Tomatoes | 8.1% | 6.0% | 4.9% | 6.7% |
| Potatoes | 9.5% | 10.2% | 10.7% | 8.6% |
| Paraffin | 7.7% | 37.5% | -10.6% | 9.9% |
| Exempt Items | | | | |
| Suburban Train | -10.3% | 36.3% | 6.1% | 10.0% |
| Bus | 6.8% | 36.4% | 2.9% | 11.5% |
| Standard rated Items | | | | |
| Doctors visit (GP) | 13.5% | 34.1% | 15.3% | 14.9% |
| Aspirin | 12.5% | 13.6% | 11.2% | 11.4% |
| Newspaper | 16.2% | 11.6% | 8.8% | 13.3% |

*Source of basic data: Statistics South Africa*

These average rates of price increase are contrasted with rates of increase in certain related sub-categories of the Consumer Price Index in Table 39 below.

**Table 39: Average increases in components of the CPI**

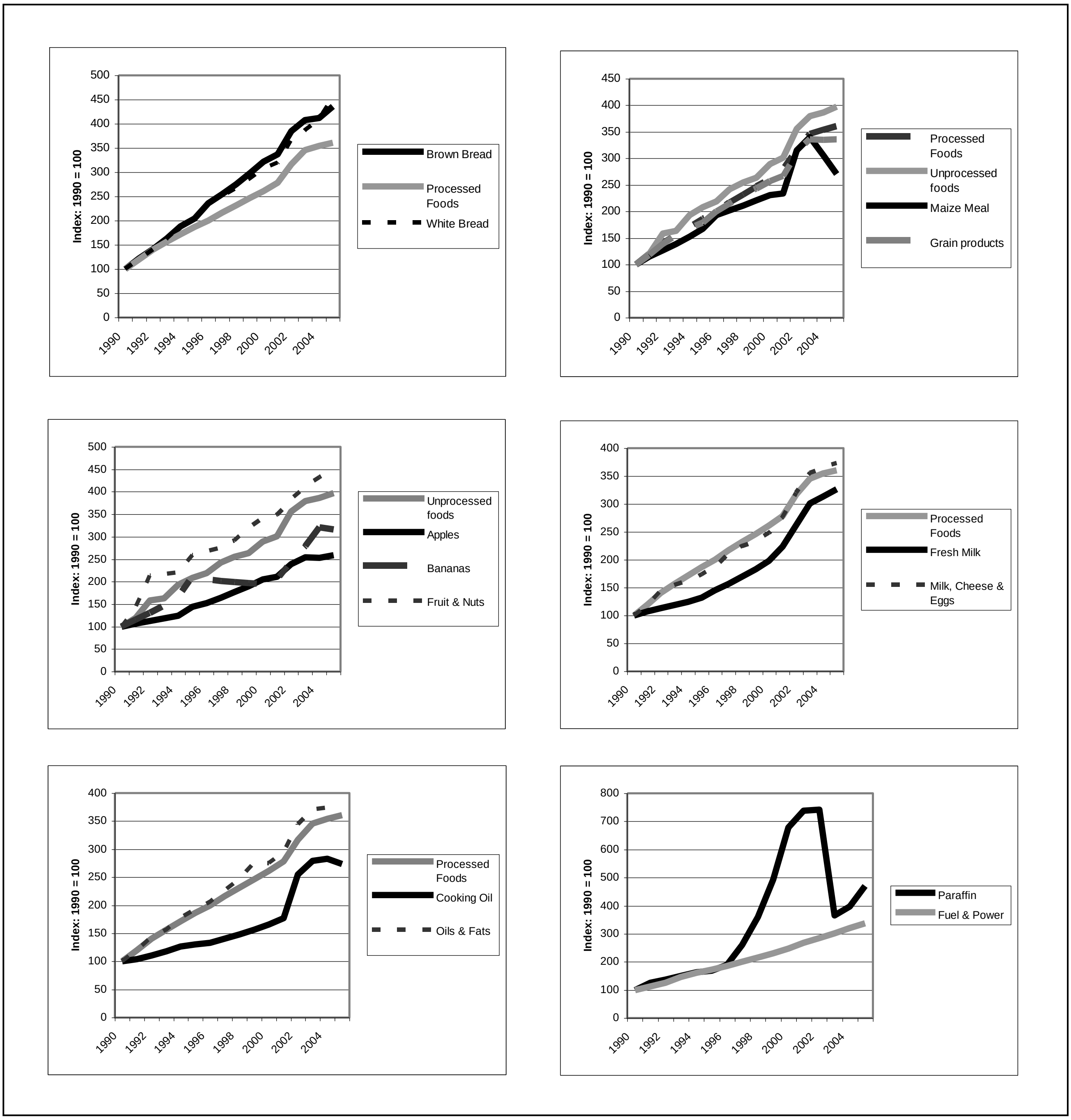
| CPI Product Category | Average annual increase in prices | | | |
|---|---|---|---|---|
| | 1991 – 1995 | 1996 - 2000 | 2001 - 2005 | 1991 – 2005 |
| All items | 10.3% | 6.5% | 4.9% | 7.1% |
| Food (All) | 13.4% | 7.1% | 7.0% | 8.6% |
| Food: Processed | 11.7% | 6.9% | 6.7% | 8.2% |
| Food: Unprocessed | 14.8% | 7.2% | 7.2% | 8.9% |
| Food: Grain products | 10.9% | 6.3% | 5.9% | 7.7% |
| Food: Meat | 15.5% | 5.8% | 7.5% | 8.8% |
| Food: Fish & other seafood | 10.4% | 7.9% | 5.5% | 8.1% |
| Food: Milk, cheese & eggs | 9.9% | 7.4% | 7.8% | 8.5% |
| Food: Fats and oils | 12.6% | 7.5% | 6.0% | 8.4% |
| Food: Fruit and nuts | 16.2% | 6.2% | 6.5% | 8.6% |
| Food: Vegetables | 16.4% | 10.6% | 7.7% | 10.3% |
| Fuel and power | 11.4% | 7.6% | 6.0% | 8.2% |
| Health | 13.3% | 12.6% | 9.5% | 11.5% |
| Transport | 10.9% | 7.1% | 5.1% | 7.5% |
| Transport: Running cost | 9.4% | 10.4% | 7.7% | 9.3% |
| Transport: Public & hired transport | 8.2% | 2.8% | 1.6% | 4.2% |
| Reading matter | 13.9% | 9.0% | 5.7% | 9.5% |
| Education | 24.1% | 12.6% | 8.9% | 14.3% |

*Source: S A Reserve Bank*

Figure 8 below indicates comparative price movements for a number of different products between 1991 and 2005. There is no indication from either the tables above or the graphs below that the price increases of zero-rated items following the introduction of VAT were consistently higher than the price increases of other products and related product categories. In fact, with the exception of brown bread and paraffin[91], the price increases in the zero-rated items listed were generally lower than related categories of products. However, it should be borne in mind that most of the products zero-rated for VAT purposes were also exempt from GST so the benefits of differential treatment may well have been eroded prior to the introduction of VAT.

[91] In the case of brown bread prices accelerated at a faster rate than white bread between 1996 and 2004. However, this could have been the result of shifting demand patterns brought about by perceived health benefits, and probably had little to do with the VAT status of the respective products. In the case of paraffin, the price is regulated and is influenced predominantly by international prices and exchange rate movements.

**Figure 8: Comparative increases in prices of zero-rated and standard rated products**



## Conclusions

The preceding analysis indicates that very low and low income households (as defined in this study) will derive limited benefits from preferential VAT treatment of the proposed merits goods because these products are largely unaffordable or of a low priority to these groups. In some instances they can access medical services and medicines free through the public health system. Targeted assistance in the form of fiscal expenditures (through grants and/or subsidies) seems more appropriate to reach these groups.

With the exception of maize-meal, bread flour and mealie rice, the existing zero-ratings and exemptions do very little to address the regressivity of the VAT system. In fact they serve to make the VAT system more regressive by transferring substantially more benefits from preferential product treatment to higher income groups than those that flow to lower income groups. The adoption of a more favourable VAT dispensation in respect of any of the proposed new merit goods would also not serve to offset the perceived regressivity of VAT. This tends to support the view contained in Chapter 2 that VAT concessions will only serve to reduce the regressivity of VAT if the spending patterns of the lower income groups are viewed in isolation. When account is taken of the spending of higher income groups, zero-rating, exemption and the adoption of lower VAT rates actually tend to exacerbate any regressivity in the VAT system.

These results call into question the use of zero-rating and exemption in relation to basic foodstuffs and other items, and suggest that there should be more effective methods of assisting the poor through fiscal expenditures and transfers. For example, the standard rating of the existing zero-rated and exempt products studied could (taken in isolation, and excluding income and substitution effects) provide the fiscus with additional tax revenue that could fund an increase in social grants of more than 10% (or around R91 per month), which would far exceed any additional amounts of VAT that these households would pay.

An analysis of the economic incidence of VAT in respect of some currently zero-rated products indicates that suppliers of both maize meal and fresh milk benefit to a greater extent from the zero-rating than consumers. By contrast, the bulk of the benefits arising from the VAT zero-ratings on rice and brown bread currently accrue to consumers. When the analysis was extended to take account of the economic incidence of VAT on products that have been proposed as warranting merit good status, the results confirmed consumers of both prescription and non-prescription medicines would probably only enjoy around 40% - or less – of any potential savings facilitated by a change in the VAT treatment of these products. In the case of books, the VAT incidence currently falls predominantly on the suppliers of books, which means that if VAT were to be removed, consumers would probably only receive around 13% of any facilitated potential reduction in price.

It would appear that rising average real income levels will have a more significant role to play in facilitating increased consumption of meritorious products than changes in prices as a result variations in their VAT treatment. The growth in household disposable incomes over time will be influenced by the levels of efficiency of the economy rather than by changes in the price of specific products. A VAT system that embodies the lowest possible excess burden, and which is the most efficient in generating revenue to fund social and redistributive expenditures will therefore tend to support higher levels of income growth over time.

The extension of the analysis to market behavioural trends, (as indicated by pricing behaviour over time) does not suggest that the existing VAT dispensation has facilitated profiteering on the part of suppliers. In fact, with the exception of brown bread and paraffin, the price increases in the zero-rated items listed were generally lower than related categories of products. Since most of the products zero-rated for VAT purposes were also exempt from GST it may, however, be the case that the benefits to consumers of differential treatment were eroded prior to the commencement of VAT.

# Chapter 6: Fiscal impact assessment

## Introduction

The analysis of the VAT treatment of merit goods and services also needs to consider whether the specific objectives of the favourable treatment are being met, as well as the potential costs to the fiscus. The preceding chapter provided an assessment of the likelihood that the objectives of some form of preferential VAT treatment would be achieved. This chapter focuses on the anticipated impact of existing and contemplated zero-ratings and exemptions on the fiscus.

Such an assessment is made more complex by a range of factors, many of which have been discussed in preceding chapters of this study. They include:

- The short term economic incidence, which encompasses a partial equilibrium analysis of the impact of the imposition (or removal) of a tax on a product. This analysis relies on estimates of the respective price elasticities of demand and supply of the products concerned.
- The longer-term economic incidence, which takes account of both the income elasticities of demand and certain indirect effects flowing from changes to relative prices.
- Efficiency considerations, including the concept of excess burden and changes to returns on investment related to shifts in demand and supply between different markets.

## Short term (direct) impact

An analysis of relative price elasticities and tax incidence is relevant to any discussion of the fiscal impact because changes in the selling price of a product impact on the quantity of that product consumed. The potential direct fiscal "losses" arising from changes to the existing dispensation will therefore tend to vary from the assessments of the VAT portion of the current sales value of different products that is either gained (in the case of VAT being imposed on products that were previously zero-rated) or lost (in the case of a more favourable VAT dispensation being adopted). The extent of this variation will largely be determined by the price elasticities of demand of those products. However, a comprehensive analysis of this sort has not been attempted because of an inability to obtain reliable estimates of price elasticities of demand and supply for a wide variety of affected products.

## Estimates of VAT collections

Table 40 below indicates the estimated value of VAT that was either foregone, or which would have been foregone in the event of a change to the current dispensation. This analysis is based purely on the estimated values of household consumption expenditure on those products in 2006,[92] and does not incorporate changes in demand as a result of their VAT treatment.

**Table 40: Value of VAT collections and concessions in 2006**

| Current VAT Status | Product | Estimated value of spending by Households in 2006 (Rm) | Estimated value of VAT foregone in 2006 (Rm) | Estimated value of VAT collected in 2006 (Rm) |
|---|---|---|---|---|
| Zero-rated | Mealie meal | 14,002.4 | 1,960.3 | 0 |
| | Bread flour | 2,317.7 | 324.5 | 0 |
| | Rice | 6,235.4 | 873.0 | 0 |
| | Mealie rice | 1,749.5 | 244.9 | 0 |
| | Brown bread | 11,867.0 | 1,661.4 | 0 |
| | Cooking oils | 9,921.6 | 1,389.0 | 0 |
| | Fresh milk | 6,786.8 | 950.1 | 0 |
| | Sour milk | 1,132.6 | 158.6 | 0 |
| | Milk powder | 1,821.9 | 255.1 | 0 |
| | UHT milk | 1,225.3 | 171.5 | 0 |
| | Eggs | 4,550.3 | 637.0 | 0 |
| | Potatoes | 5,299.2 | 741.9 | 0 |
| | Mealies | 349.9 | 49.0 | 0 |
| | Tomatoes | 3,272.3 | 458.1 | 0 |
| | Lettuce | 449.0 | 62.9 | 0 |
| | Apples | 32.8 | 4.6 | 0 |
| | Bananas | 13.3 | 1.9 | 0 |
| | Oranges | 659.0 | 92.3 | 0 |
| | Paraffin | 328.8 | 46.0 | 0 |
| Exempt[93] | Public transport – buses | 73.3 | 4.7 | 5.2 |
| | Public transport – trains | 910.0 | 57.9 | 64.5 |
| | Public transport – metered cab | 483.6 | 30.8 | 34.3 |
| | Public transport – other | 128.6 | 8.2 | 9.1 |
| | Education – pre-primary | 4,378.3 | 306.6 | 286.3 |
| | Education – public schools | 791.0 | 55.4 | 51.7 |
| | Education – private schools | 235.2 | 16.5 | 15.4 |
| | Teachers training colleges | 96.1 | 6.7 | 6.3 |
| | Universities | 1,670.9 | 117.0 | 109.3 |
| Standard rated | Water | 13,044.5 | 0 | 1,602.0 |
| | Electricity | 15,037.5 | 0 | 1,846.7 |
| | Medicines with prescription | 321.7 | 0 | 39.5 |
| | Health services not covered by medical aid | 150.1 | 0 | 18.4 |

[92] The weights derived from the 2000 Income and Expenditure Survey were applied to 2006 figures for final consumption expenditure by households
[93] Values of VAT collected and foregone based on estimates of the value added at the final stage of supply in relation to all other stages.

| Current VAT Status | Product | Estimated value of spending by Households in 2006 (Rm) | Estimated value of VAT foregone in 2006 (Rm) | Estimated value of VAT collected in 2006 (Rm) |
|---|---|---|---|---|
| | Medicines without prescription | 35.0 | 0 | 4.3 |
| | Flat fee medical services | 18.7 | 0 | 2.3 |
| | Doctors and dentists | 1,708.6 | 0 | 209.8 |
| | Non-medical aid medicines with prescription | 485.7 | 0 | 59.6 |
| | Non-medical aid medicines without prescription | 316.6 | 0 | 38.9 |
| | Textbooks | 2,188.1 | 0 | 268.7 |
| | Newspapers | 1,159.6 | 0 | 142.4 |
| | Magazines | 227.7 | 0 | 28.0 |
| | Books | 763.9 | 0 | 93.8 |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

Taken in isolation, the direct VAT foregone on the existing zero-rated and exempt products studied amounted to some R10.7 billion in 2006. This implies that when taken in isolation, and excluding income and substitution effects, the removal of all such zero-ratings and exemptions in a revenue-neutral manner would facilitate a reduction in the current standard VAT rate of around 1.1 percentage points (from 14% to around 12.9%).

## Implications of zero-rating standard rated products

If products that are currently standard rated but deemed to be merit goods and are therefore, zero-rated, then this would necessitate increases in VAT collections from other sources for such changes to be revenue neutral. The implications of changes to the current VAT dispensation for VAT collections and the VAT rate to be revenue neutral are indicated in the tables below.

### Table 41: Implied reductions in VAT collections and the VAT rate if zero-ratings were removed – static model

| Product | Estimated value of VAT foregone in 2006 (Rm) | Implied % by which other VAT collections and the VAT rate could be reduced if currently zero-rated product was standard rated[94] | |
|---|---|---|---|
| | | Potential reduction in other VAT collections (2006 figures) | Potential reduction in the VAT standard rate (percentage points) |
| Mealie meal | 1,960.3 | 1.5% | 0.21% |
| Bread flour | 324.5 | 0.2% | 0.04% |
| Rice | 873.0 | 0.6% | 0.09% |
| Mealie rice | 244.9 | 0.2% | 0.03% |
| Brown bread | 1,661.4 | 1.2% | 0.18% |
| Cooking oils | 1,389.0 | 1.0% | 0.15% |
| Fresh milk | 950.1 | 0.7% | 0.10% |
| Sour milk | 158.6 | 0.1% | 0.02% |
| Milk powder | 255.1 | 0.2% | 0.03% |
| UHT milk | 171.5 | 0.1% | 0.02% |
| Eggs | 637.0 | 0.5% | 0.07% |
| Potatoes | 741.9 | 0.6% | 0.08% |
| Mealies | 49.0 | 0.0% | 0.01% |
| Tomatoes | 458.1 | 0.3% | 0.05% |
| Lettuce | 62.9 | 0.0% | 0.01% |
| Apples | 4.6 | 0.0% | 0.00% |
| Bananas | 1.9 | 0.0% | 0.00% |
| Oranges | 92.3 | 0.1% | 0.01% |
| Paraffin | 46.0 | 0.0% | 0.00% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

[94] If a currently zero-rated product was to be standard-rated, this would result in an increase in VAT collections. If any changes were to be neutral with respect to VAT collections, then such a change would facilitate a reduction in existing collections. The reduction could be achieved by reducing the existing VAT rate

## Table 42: Implied reductions in VAT collections and the VAT rate if exemptions were removed – static model

| Product | Estimated value of VAT foregone in 2006 (Rm) | Implied % by which VAT collections and the VAT rate could be reduced if currently exempt product was standard rated | |
|---|---|---|---|
| | | Potential reduction in VAT collections (% reduction in 2006 figures) | Potential reduction in the VAT standard rate (percentage points) |
| Public tpt – buses | 4.7 | 0.0% | 0.00% |
| Public tpt – trains | 57.9 | 0.0% | 0.01% |
| Public tpt – metered cab | 30.8 | 0.0% | 0.00% |
| Public tpt – other | 8.2 | 0.0% | 0.00% |
| Education – pre-primary | 306.6 | 0.2% | 0.03% |
| Education – public schools | 55.4 | 0.0% | 0.01% |
| Education - private schools | 16.5 | 0.0% | 0.00% |
| Teachers training colleges | 6.7 | 0.0% | 0.00% |
| Universities | 117.0 | 0.1% | 0.01% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

## Table 43: Implied increases in VAT collections and the VAT rate if exempt products were zero-rated – static model

| Product | Estimated value of VAT collected in 2006 (Rm) | Implied % by which VAT collections and the VAT rate would need to be increased if currently exempt product was zero rated[95] | |
|---|---|---|---|
| | | Required increase in VAT collections (% increase in 2006 figures) | Required increase in the VAT standard rate (percentage points) |
| Public tpt – buses | 5.2 | 0.0% | 0.00% |
| Public tpt – trains | 64.5 | 0.0% | 0.01% |
| Public tpt – metered cab | 34.3 | 0.0% | 0.00% |
| Public tpt – other | 9.1 | 0.0% | 0.00% |
| Education – pre-primary | 286.3 | 0.2% | 0.03% |
| Education – public schools | 51.7 | 0.0% | 0.01% |
| Education – private schools | 15.4 | 0.0% | 0.00% |
| Teachers training colleges | 6.3 | 0.0% | 0.00% |
| Universities | 109.3 | 0.1% | 0.01% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

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[95] If a currently exempt or standard-rated product was to be zero-rated, this would result in a reduction in VAT collections. If any changes were to be neutral with respect to VAT collections, then such a change would an increase in existing collections. This increase could be achieved by increasing the existing VAT rate

**Table 44: Implied increases tax revenues if standard rated products were zero-rated – static model**

| Product | Estimated value of VAT collected in 2006 (Rm) | Implied % by which VAT collections and the VAT rate would need to be increased if currently exempt product was zero rated[96] | |
|---|---|---|---|
| | | Required increase in VAT collections (% increase in 2006 figures) | Required increase in the VAT standard rate (percentage points) |
| Water | 1,602.0 | 1.2% | 0.17% |
| Electricity | 1,846.7 | 1.4% | 0.20% |
| Medicines with prescription | 39.5 | 0.0% | 0.00% |
| Health services not covered by medical aid | 18.4 | 0.0% | 0.00% |
| Medicines without prescription | 4.3 | 0.0% | 0.00% |
| Flat fee medical services | 2.3 | 0.0% | 0.00% |
| Doctors and dentists | 209.8 | 0.2% | 0.02% |
| Non-medical aid medicines with prescription | 59.6 | 0.0% | 0.01% |
| Non-medical aid medicines without prescription | 38.9 | 0.0% | 0.00% |
| Textbooks | 268.7 | 0.2% | 0.03% |
| Newspapers | 142.4 | 0.1% | 0.02% |
| Magazines | 28.0 | 0.0% | 0.00% |
| Books | 93.8 | 0.1% | 0.01% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

The above figures understate expenditure on medicines because they do not capture spending on medical scheme contributions, or the spending by medical schemes on medicines on behalf of members. The above figures only provide estimates of direct, “out-of-pocket” expenditure by households on medicines. The National Department of Health estimates that the total value of medicines purchased by medical schemes on behalf of members was R6.7 billion in 2005. The VAT portion of this would have been around R823 million. If these medicines were to be zero-rated, it would require and increase in VAT collections of 0.6% on the 2006 collections. This would require an increase in the VAT rate of around 0.09 percentage points if such a concession was to be revenue neutral.

[96] See footnote 113.

With a few notable exceptions (such as maize meal, brown bread, cooking oils, electricity and water) changes in the VAT treatment of individual products would have relatively insignificant implications for VAT collections and adjustments to the VAT rate in order to maintain tax neutrality. However, collectively, the combined impact would be more pronounced, as the 1.1 percentage point potential reduction in the VAT rate facilitated by the standard rating of products that are currently zero-rated or exempt suggests. If all the currently exempt and standard rated products included in the above tables were zero-rated, the R4.9 billion “loss” would need to be offset by an increase in the VAT rate of around 0.5 percentage points.

## Longer-term (induced) impact

The short term, partial equilibrium analysis of the fiscal impact of changes to the existing VAT dispensation outlined in the section above does not provide a complete perspective of the probable longer-term impact of such changes because it treats each product market in isolation. In reality, changes in the prices of only some products as a result of variations in their VAT treatment leads to changes in relative prices, and gives rise to income and substitution effects that can result in substantially different economy-wide outcomes.

### Economy-wide implications of changes to the current VAT dispensation

A reduction in the price of a normal product as a result of a more favourable VAT dispensation will result in an increase in real incomes. This gain in purchasing power should give rise to an increase in the quantity demanded of that product, but it is also likely that some of the VAT “savings” will be spent on other products. Many, if not most, of these products will still be subject to VAT at the standard rate. At the same time, changes in relative prices as a result of a different VAT treatment will also give rise to a substitution effect. Because the price of the product receiving the more favourable VAT dispensation is now relatively lower than other products, it is likely that there will be a shift in demand towards the relatively lower-priced product from the relatively higher priced products. This would normally imply that VAT collections on other products would be reduced.

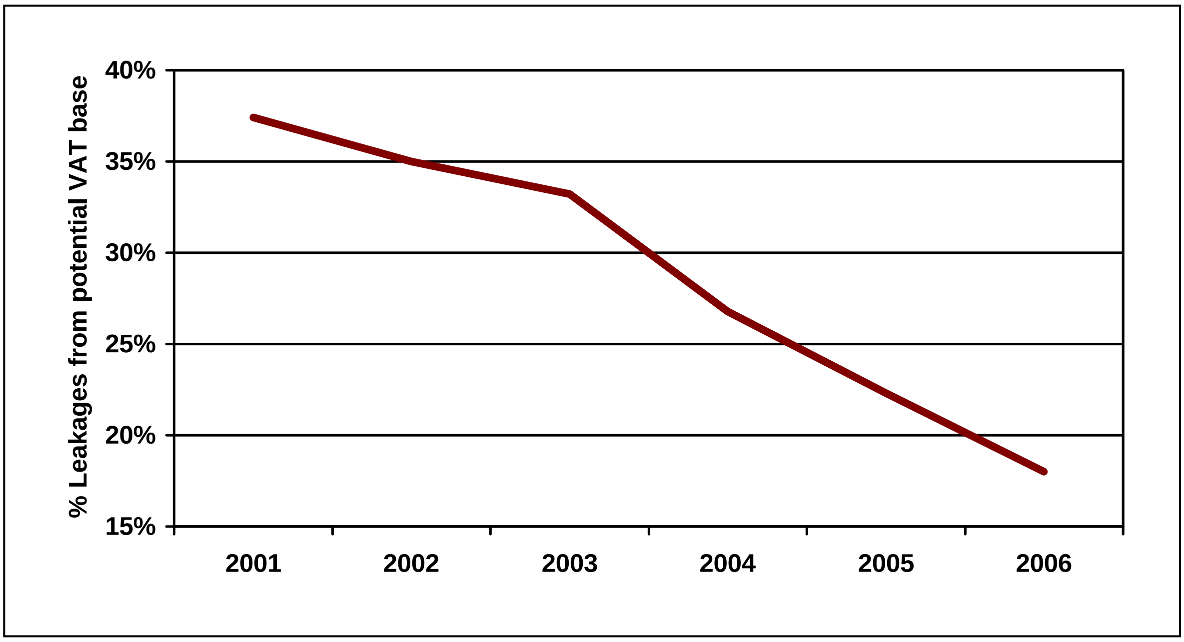
If they persist, these shifts in demand patterns as a result of the income and substitution effects will, in turn, give rise to changes in investment, employment and income-earning patterns in different markets in the economy. Whereas the short-term impact outlined above could be described as the “direct impact” of changes to the existing VAT dispensation, the longer-term, economy-wide impact would be “induced”.

## Estimates of economy-wide gains and losses

Estimating the full impact of such changes would require a general (as opposed to a partial) equilibrium analysis that is beyond the immediate scope of this study. However, as a proxy for such an analysis, it may reasonably be assumed that the "final" loss to the fiscus of the adoption of a more favourable VAT dispensation for individual merit goods will approximate the ratio of the VAT leakages expressed as a percentage of the potential VAT base (see footnote 115 below) to the direct VAT losses outlined in the short term impact section above. In 2006 these VAT leakages are estimated at 18 % of the potential VAT base on household consumption expenditure. In other words, as a result of zero-ratings, exemptions and other leakages, the fiscus collects around 18 % less VAT from households than it would if there were no leakages.

It is notable from Figure 9 below that the estimated percentage of these leakages has declined substantially in recent years from around 37.5% in 2002 to the 18% referred to above. This decrease can probably be ascribed in large measure to improved compliance, since there were not any significant changes in VAT legislation over this period, but could also be a consequence of a movement away from zero-rated products as a result of social changes and rising average incomes, and an under-estimation of household consumption expenditure (and by inference GDP). The shift in spending patterns could be confirmed by an analysis of household spending patterns once the 2005 Income and Expenditure Survey figures becomes available, but it does seem likely that higher incomes and lifestyle pressures have caused a shift towards prepared meals and takeaways that would result in a loss of some of the benefits of existing zero-ratings.

**Figure 9: Estimated leakages[97] from the potential VAT base on household consumption expenditure**




*Sources: South African Reserve Bank Quarterly Bulletin*
*National Treasury estimates*

Given the relatively small share of each individual product in the average consumption expenditure of households, and assuming that the average household's spending patterns do not change markedly as a consequence of a change in the VAT treatment of merit goods, it can be assumed that the long term "loss" to the fiscus arising from a VAT change would be around 18%[98] of the initial (direct) losses. Similarly, the potential VAT gains from standard rating products that are currently either zero-rated or exempt will be similarly muted. The actual extent of such losses (or gains) would be influenced by a number of factors, including:

- further improvements in compliance;
- the cumulative share of household consumption spending of zero-rated and exempt products;
- the standard rate of VAT.

[97] Actual VAT collections were adjusted to exclude the estimated proportion of VAT paid on final consumption expenditure by general government, and on intermediate supplies in order to estimate actual collections arising from final consumption expenditure by households. The difference between this figure, and the potential VAT that could be collected on household consumption if there were no leakages (i.e. no VAT exceptions and full compliance) is expressed as a percentage of this potential VAT base.
[98] This percentage would increase as additional products consumed by households were afforded favourable VAT treatment.

On this basis, the long term potential gains to the fiscus of standard rating products that are currently zero-rated or exempt, and the losses[99] to the fiscus of zero-rating products that are currently exempt or standard rated are as shown in the tables below. The decreases and increases in VAT collections and the associated adjustments to the VAT rate required to neutralise such gains and losses are also indicated.

**Table 45: Implied reductions in VAT collections and the VAT rate if zero-rated products were standard rated – economy-wide**

| Product | Estimated economy-wide, long-term annual value of VAT foregone (Rm) | Implied % by which VAT collections and the VAT rate could be reduced if currently zero-rated product was standard rated | |
|---|---|---|---|
| | | Potential reduction in VAT collections (2006 figures) | Potential reduction in the VAT standard rate (percentage points) |
| Mealie meal | 352.9 | 0.3% | 0.04% |
| Bread flour | 58.4 | 0.0% | 0.01% |
| Rice | 157.1 | 0.1% | 0.02% |
| Mealie rice | 44.1 | 0.0% | 0.00% |
| Brown bread | 299.0 | 0.2% | 0.03% |
| Cooking oils | 250.0 | 0.2% | 0.03% |
| Fresh milk | 171.0 | 0.1% | 0.02% |
| Sour milk | 28.5 | 0.0% | 0.00% |
| Milk powder | 45.9 | 0.0% | 0.00% |
| UHT milk | 30.9 | 0.0% | 0.00% |
| Eggs | 114.7 | 0.1% | 0.01% |
| Potatoes | 133.5 | 0.1% | 0.01% |
| Mealies | 8.8 | 0.0% | 0.00% |
| Tomatoes | 82.5 | 0.1% | 0.01% |
| Lettuce | 11.3 | 0.0% | 0.00% |
| Apples | 0.8 | 0.0% | 0.00% |
| Bananas | 0.3 | 0.0% | 0.00% |
| Oranges | 16.6 | 0.0% | 0.00% |
| Paraffin | 8.3 | 0.0% | 0.00% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

[99] The gains and losses reflected here only relate to VAT. It is likely that changes to relative prices as a result of variations in the VAT treatment of products could give rise to shifts in other tax collections over the longer term.

**Table 46: Implied reductions in VAT collections and the VAT rate if exempt products were standard rated – economy-wide**

| Product | Estimated economy-wide, long-term annual value of VAT foregone (Rm) | Implied % by which VAT collections and the VAT rate could be reduced if currently exempt product was standard rated | |
|---|---|---|---|
| | | Potential reduction in VAT collections (2006 figures) | Potential reduction in the VAT standard rate (percentage points) |
| Public tpt – buses | 0.8 | 0.0% | 0.00% |
| Public tpt – trains | 10.4 | 0.0% | 0.00% |
| Public tpt – metered cab | 5.5 | 0.0% | 0.00% |
| Public tpt – other | 1.5 | 0.0% | 0.00% |
| Education – pre-primary | 55.2 | 0.0% | 0.01% |
| Education – public schools | 10.0 | 0.0% | 0.00% |
| Education - private schools | 3.0 | 0.0% | 0.00% |
| Teachers training colleges | 1.2 | 0.0% | 0.00% |
| Universities | 21.1 | 0.0% | 0.00% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

**Table 47: Implied increases in VAT collections and the VAT rate if exempt products were zero rated – economy-wide**

| Product | Estimated economy-wide, long-term annual value of VAT collected (Rm) | Implied % by which VAT collections and the VAT rate would need to be increased if currently exempt product was zero rated | |
|---|---|---|---|
| | | Required increase in VAT collections (2006 figures) | Required increase in the VAT standard rate (percentage points) |
| Public tpt – buses | 0.9 | 0.0% | 0.00% |
| Public tpt – trains | 11.6 | 0.0% | 0.00% |
| Public tpt – metered cab | 6.2 | 0.0% | 0.00% |
| Public tpt – other | 1.6 | 0.0% | 0.00% |
| Education – pre-primary | 51.5 | 0.0% | 0.01% |
| Education – public schools | 9.3 | 0.0% | 0.00% |
| Education - private schools | 2.8 | 0.0% | 0.00% |
| Teachers training colleges | 1.1 | 0.0% | 0.00% |
| Universities | 19.7 | 0.0% | 0.00% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

**Table 48: Implied increases in different taxes if standard rated products were zero-rated – economy-wide**

| Product | Estimated economy-wide, long-term annual value of VAT collected (Rm) | Implied % by which VAT collections and the VAT rate would need to be increased if currently standard rated product was zero rated | |
|---|---|---|---|
| | | Required increase in VAT collections (2006 figures) | Required increase in the VAT standard rate (percentage points) |
| Water | 288.4 | 0.2% | 0.03% |
| Electricity | 332.4 | 0.3% | 0.04% |
| Medicines with prescription | 7.1 | 0.0% | 0.00% |
| Health services not covered by medical aid | 3.3 | 0.0% | 0.00% |
| Medicines without prescription | 0.8 | 0.0% | 0.00% |
| Flat fee medical services | 0.4 | 0.0% | 0.00% |
| Doctors and dentists | 37.8 | 0.0% | 0.00% |
| Non-medical aid medicines with prescription | 10.7 | 0.0% | 0.00% |
| Non-medical aid medicines without prescription | 7.0 | 0.0% | 0.00% |
| Textbooks | 48.4 | 0.0% | 0.01% |
| Newspapers | 25.6 | 0.0% | 0.00% |
| Magazines | 5.0 | 0.0% | 0.00% |
| Books | 16.9 | 0.0% | 0.00% |

*Sources of basic data: Statistics South Africa, SA Reserve Bank, National Treasury*

It is, once again, worth noting that the above figures understate expenditure on medicines because they do not capture spending on medical scheme contributions, or the spending by medical schemes on medicines on behalf of members. The above figures only provide estimates of direct, “out-of-pocket” expenditure by households on medicines. When account is taken of the National Department of Health estimates of R6.7 billion spent by medical schemes on medicines in 2005, the long-term economy-wide losses of the zero-rating of these products could amount to around R148 million per annum (at 2006 prices). For such a concession to be revenue neutral, it would require that VAT collections were increased by 0.1%, equating to an increase in the VAT rate of 0.02 percentage points.

In the light of the muted longer-term losses outlined above, it is not surprising that the adjustments required in order to offset variations in the VAT treatment of specific products are quite limited. It should, however, be recognised that the adoption of a more favourable VAT treatment for merit goods and services would usually encompass whole categories of products (such as “medicines”, “books” or “public transport”), in which case the adjustments required would be more pronounced. In the case of products that carry a comparatively larger weighting in the average household consumer basket (such as water and electricity), the standard rate of VAT would need to be increased by around 0.03 percentage points for each of these products in order to offset the long term erosion of the VAT base. The VAT rate would need to be increased by 0.01 percentage points in each case if all the categories of medical expenditure (excluding medical aid contributions), education expenditure and printed material expenditure were to be zero-rated.

## Other fiscal implications of changing the current VAT dispensation

The direct impact of changing the current VAT dispensation in respect of merit goods either zero-rating, exempting, or adopting additional VAT rates, could be quantified with the right data. Depending on the rates or treatment selected, collections would be proportionately adjusted. However, there would also be other administrative and compliance costs associated with such changes, to both the South African Revenue Service (SARS) and registered vendors. These are harder to quantify and are addressed in Chapter 8 of this study.

## Conclusions

If the empirical analysis of the fiscal impact of existing and/or proposed zero-ratings and exemptions is limited to the 2006 value of the VAT portion of total household consumption spending on a particular product, then the fiscal impact is quite marked. Depending on the weight of the product in the household basket, the putative "losses" to the fiscus could range from almost R2 billion in the case of maize meal and electricity, to as little as R1.9 million for a product such as bananas.

However, the actual loss to the fiscus would be substantially more muted than these figures suggest. Because any "savings" arising from preferential VAT treatment would generate income and substitution effects, it is likely that the actual loss to the fiscus would approximate the ratio of the percentage share of the VAT leakages of the potential VAT base on household consumption expenditure of the initial or direct VAT loss referred to above. Currently, this would amount to a final, economy-wide loss of around 18% of the VAT portion of current spending. This translates into losses ranging from around R350 million per annum (at 2006 prices) in the case of maize meal to around R300 000 per annum in the case of bananas. The final fiscal losses associated with the zero-rating of books would only amount to about R17 million per annum. On the other hand, these figures also mean that the additional VAT that would be generated because of the standard rating of a product that is currently zero-rated would also be similarly muted.

As a result of the diluted fiscal impact, the adjustments required to the standard VAT rate to offset losses arising from additional zero-ratings, or gains from the removal of existing VAT concessions, would be quite limited. For example, the zero-rating of electricity would necessitate an increase of around 0.24% in VAT collections (which translates into an increase of the current VAT rate of 0.03 percentage points, i.e. to 14.03%. In the case of books, final VAT losses would require an increase in the VAT base of only 0.01%.

The arguments against the introduction of additional VAT exceptions to accommodate merit goods and services on the basis of fiscal affordability would therefore tend to be relatively weak in relation to individual products. The costs to the fiscus would, however, become more pronounced if whole categories of products – such as utilities, medical services and medicines, and printed material - were given favourable treatment.  To be revenue neutral, the zero-rating of such categories of products would require increases in the VAT rate of around 0.07, 0.01, and 0.01 percentage points respectively.

# Chapter 7: Policy impact assessment

## Introduction

The anticipated impact of changes to the VAT treatment of the relevant merit goods or services on the essential policy considerations of equity, efficiency, simplicity and neutrality of the VAT system must be considered to ensure that the implications of any potential change are well considered.

This analysis is necessary to determine whether changed circumstances and times justify (or necessitate) VAT reform regarding the VAT treatment of these goods or services.

## Equity

### Zero-rating

#### *Basic foodstuffs*

It is often argued that as food absorbs a larger part of the budget of the poor households rather than that of rich households, zero-rating food makes the VAT less regressive. Zero rate must, however, always apply only at the last stage of the production or distribution chain.[100]

The biggest problem of allowing concessionary treatment to promote progressivity of VAT is that the concession could in fact result in less progressivity. While poor households use a larger part of their income for basic necessities such as food, shelter and basic municipal services, a concession for these basic or essential goods or services, will mean that the more affluent also do not have to pay VAT on these basic commodities. Further, the affluent use the basic necessities in larger quantities and volumes by them. For example, if fresh fruit and vegetables, being an essential requirement for basic food and general good health of the population are afforded special treatment, such as by way of the present zero-rating in South Africa, not only poor households benefit from the zero-rating. The affluent and rich households buy the best quality and even imported fruit and vegetables, often in cut and ready for use form at high prices, without having to pay any VAT.

It has been argued that basic necessities should be zero-rated only if sold to poor households for whom a zero-rating would reduce regressivity. However, it is simultaneously acknowledged that trying to distinguish those households might prove impractical.[101]

[100] Shoud o*p cit* 146.
[101] Supra 147.

### *Electricity or water*

Equity will not necessarily be promoted if household consumption of electricity or water is zero-rated. The affluent will merely pay less for the large volumes of electricity or water used for luxuries such as using electricity for dishwashers, air conditioners, fridges and other electrical appliances and using water to fill swimming-pools, for dishwashers, automatic washing machines, saunas and watering their gardens, will also be benefited by the zero rate.

These examples clearly illustrate the potential for regressivity to worsen should a blanket concession be granted for basic or essential goods or services: The distributional consequences of concessions could favour the richer households relative more, with only limited benefits for the poor.[102]

It could be argued that the concession should merely be carefully designed to apply only to the target group, for whom the VAT is regressive. Instead of allowing a general zero-rating for electricity, only consumption at certain basic levels could be zero-rated, thereby reducing the level of subsidisation for the affluent. However, such an attempt to target assistance to the needy would still not accurately take account of income differentials, as it must assume that all consumption up to a certain level is basic, and all consumption thereafter is by people who can afford it. Another option would be to implement higher rates, based on a sliding scale of consumption to promote the progressiveness of the VAT. It would, however, not take into account the household structure of poorer families, where various generations, extended family and even friends are forced to stay under one roof. Their combined electricity consumption for basic use of appliances could equal or even exceed the use by an affluent couple, living in an up-market residence using luxury appliances.

## Exemption

### *Passenger transport*

The exemption of passenger transport by road or rail was mainly aimed at the needy who do not have their own vehicles for transport purposes, and who would not have been able to pay more for bus and train fares if VAT had to be added to the price. However, the blanket exemption might have increased inequality, as the more affluent using mainline passenger transport provided by luxury coach transport and touring operators also enjoy the benefits of the exemption. In addition, the fact that an expensive trip on the luxurious blue train, which is affordable only to the rich, is exempt from VAT has been criticised. However, it seems that public transport was initially exempted not so much to promote progressivity or help the poor, but to prevent complicated administrative difficulties for operators using buses for both

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[102] Tait, *Broad-based tax op cit* 59.

touring and essential passenger transport purposes and the complications to get taxis to register as VAT vendors (i.e. difficult-to tax goods)..

### *Educational services*

The blanket exemption of educational services, including private schools, colleges and universities, also has the effect of granting VAT benefits to the affluent. A concession for education is normally requested and justified on merit grounds, namely that it would be unjust to tax knowledge. However, notwithstanding its merits, the exemption of education has the effect of increasing the regressivity of VAT. It could be argued that only basic education is essential and should be provided free of VAT to all South Africans, but that higher education should not be exempt. Targeted assistance by way of increased government grants to higher educational institutions could provide additional funds for awarding bursaries to poorer students, or a state-sponsored bursary and loan scheme could be introduced, or tertiary education vouchers could be provided to qualifying students.

A request for concessionary treatment of books and other printed and electronic media is often justified on the ground that books and other educational matter are essential for educational development. Levying VAT thereon results in a tax on knowledge, which is regarded as unjust. While such an argument holds true in certain circumstances, it is also true that many books, newspapers and journals are so expensive (disregarding the addition of VAT to the price), that the books, newspapers and journals are bought only by the affluent. If an exemption or other concession is allowed for these printed or electronic media, it would effectively increase regressiveness.

It must therefore be concluded that it is difficult to eliminate or even alleviate the perceived regressiveness in the VAT system by way of concessions. Distributional issues are better served by income tax and by carefully targeted payments or social assistance to households affected by the tax.[103] However, in practice concessions are made to appease public perceptions.

## Lower rates

In a developing country, zero-rating necessities might exclude so much of the potential tax base that the tax rate of the remaining sectors would have to be relatively high to yield the required fiscal income. As a compromise, it is argued that lower rates could be imposed instead of the zero rate.[104]

[103] Tait *op cit* 59.
[104] Shoup *op cit* 146.

# Efficiency and simplicity

Before analysing the impact which the zero-rating, exemption or the introduction of lower VAT rates would have on the policy goals of efficiency and simplicity, the issue of defining the scope of merit goods or services is considered.

## Definition of merit goods or services

One of the biggest practical problems of allowing concessionary treatment for merit goods or services is related to the definition. Unless the scope of the concession has been well-considered and a definition, which clearly lays down the ambit of the concession, is provided in the legislation, the important policy goals of efficiency and simplicity will not be achieved.

Ambiguous wording could result in numerous queries, disputes or even open the door for VAT fraud. If the scope of the concession results in a distortion of consumer or producer preferences, VAT neutrality will be negatively affected.

### *Medical goods and services*

Internationally medical services is generally provided relief if the services are rendered by specified registered medical practitioners, or are rendered in registered hospitals or clinics. In this manner, the scope of services qualifying for a potential concession can be controlled.

The South African Draft VAT Bill[105] provided for the exemption of services provided by registered medical practitioners, dentists, dieticians, optometrists, homeopaths, naturopaths, osteopaths, herbalists, nurses, physiotherapists, psychologists, chiropractors, masseurs and orthoptists.

The supply of goods necessary for, and subordinate and incidental to, the supply of these professional services (including medicines) were also proposed to be exempt. The supply of services, or goods necessary for and subordinate and incidental to the supply of the services, in a registered hospital or nursing home or services provided in a clinic conducted by a local authority were similarly proposed to be exempt from VAT.[106]

If medical services were allowed concessionary treatment on the basis that it amounts to merit services and/or to reduce regressivity, in view of the fact that medical services are essential and basic in nature, the question arises whether cosmetic, non-essential surgery can be regarded as being merit services in respect of which equity considerations apply.

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[105] Published on 18 June 1990.
[106] Clause 12(g) of the Draft Value-Added Tax Bill.

If such services were to be excluded from the ambit of a concession, medical practitioners performing these procedures and the relevant hospitals would have to distinguish between the nature of the medical service on the grounds of essentiality. This would create administrative difficulties for the practitioner and the hospital, similar to the problems experienced by educational institutions rendering educational services which are exempt and other taxable services.

An option would be to provide concessionary treatment for all services rendered by a registered medical practitioner in the capacity of medical practitioner. This would probably eliminate most practical problems. However, for example, where a medical practitioner also runs a beauty salon, a distinction would have to be drawn between medical services and surgery done in the capacity of registered medical practitioner and other incidental beautician or similar services.

### *Education*

In South Africa, the supply of educational services by certain qualifying educational institutions is exempt from VAT. The phase 'educational services' is not defined. While the exemption provides some relief where the services are rendered to students as final consumers, VAT is a cost where the educational services are provided to vendors, whose staff receive the training. For example, if a VAT training course is presented by a University to the employees of the company, no VAT is payable, but the course fees will include a VAT element which cannot be deducted as input tax. If the same course is presented by a firm of accountants or attorneys, the course fee will include VAT, but no trapped VAT cost. As the company can deduct the VAT on the course fees as input tax, Universities and other listed educational institutions are therefore disadvantaged in this context. The introduction of a definition of 'educational institution', which excludes business training from the ambit of the exemption would prevent the distortion in neutrality which presently occurs.

### *Books and other reading matter*

VATCOM argued that not all books, newspapers and journals are of an educational nature and thus deserving of special treatment. This cannot be denied. Further, expensive full-colour coffee table books cannot be said to be merit goods on the basis that the poor cannot afford to pay the VAT, as the poor will in any case not consider buying such books. The VAT on the books will thus not affect their consumer spending.

If, however, only prescribed books of schools, further education and training institutions and universities qualify for VAT relief, publishers might request and manipulate educational institutions to prescribe more books to prevent significant differences in prices of the books.

As far as newspapers and magazines are concerned, many countries prescribe the minimum number of editions per week, month or year as well as the maximum allowed advertising. Such a distinction could of course influence the income of newspapers and journals and would be difficult to control.

### *Water and electricity*

The question arises whether all water and electricity should be considered for potential VAT relief, or only water and electricity supplied to residential accounts should be considered. In addition, the next question would then be whether all household consumption should qualify for relief, or only basic consumption up to a fixed maximum. Relief to limited households or consumption could result in compromising the simplicity of the tax.

### *Funeral or cremation services*

Funeral and cremation services could also be regarded as merit services. , In addition, due to the fact that it amounts to an essential expense, it could increase regressivity of the VAT system.

Undertakers often provide a comprehensive package, included with the traditional funeral or cremation costs, other costs could include church or religious ceremony costs, transport cost for the family as well as other guests, food and drinks for visitors, etc. The question arises whether all these costs should qualify for zero-rating or concessionary treatment.

## Zero-rating

Governments will normally not opt for zero-rating, as the VAT yield is nil and additional costs are incurred to administer the concessions. In fact zero-rating yields a negative return for Governments. The favourable VAT treatment does not only cause problems of defining the goods or services qualifying for the concession, but could also lend itself to abuse and VAT fraud. This results in onerous requirements which must be met to substantiate the zero-rating, increasing the administrative and compliance burden on the of the vendor, as well as the auditing and control costs of the Revenue Authority which must ensure that only qualifying goods or services are zero-rated.

On the other hand, it has been argued that in some developing countries, many people are on such meagre diets and in such poor health that their ability to work is impaired. If they can receive a tax concession, their ability to buy basic necessities might increase, which could result in an increase in their productivity and ultimately in economic growth.[107] On this basis, a zero-rating aimed at reducing regressivity and improving equity of the system would also improve the efficiency of the impact of the VAT system on economic growth.

## Exemption

It is sometimes argued that exempt supplies may help simplify the administration of VAT,[108] but this argument is true only where a vendor only makes exempt supplies and is thus not obliged (or entitled) to register as a vendor.[109] Where a vendor makes exempt and taxable supplies, an exemption undoubtedly increases his administrative cost. Not only does he have to distinguish between taxable supplies and exempt supplies for purposes of charging VAT to customers, but his accounting system must be sophisticated enough to cater for apportionment calculations.

Initially an exemption for educational services was agreed to on the basis of its importance in South Africa. It was also argued that an exemption was preferred on administrative and simplicity grounds, as these educational institutions would otherwise have had to be registered as vendors, keep records and meet all the requirements of normal businesses. However, many (higher) educational institutions do not only provide exempt educational services, but are also engaged in taxable activities, (e.g. research, sale of books). Many of these institutions have been registered as vendors since the introduction of VAT.

Due to reduced subsidisation of schools and the high cost of providing educational services, educational institutions are generating own income in diverse manners. More and more smaller educational institutions, including some schools, are nowadays required to be registered as VAT vendors. As these educational institutions which are registered as vendors make taxable and exempt supplies, they have to manage the administrative complexities of making mixed supplies. Consequently, the administrative difficulties for these educational institutions under the exemption is worse than it would have been under a standard rate

[107] Shoup *op cit* 147.
[108] Tait *Value-Added Tax op cit.*
[109] This would apply where flats or houses are let as residential accommodation, being exempt supplies under section 12(c) of the VAT Act.

### Lower VAT rates

The imposition of lower VAT rates for selected merit goods would undoubtedly create a precedent for further requests for concessionary treatment. In addition, unless a rate of 0 per cent is introduced, any lower rate could merely result in pleas for a further reduction of the chosen rate.

The biggest disadvantage of lower VAT rates is the potential administrative burden and compliance costs caused by the lower rates. If, for example, it were to be decided to provide a lower VAT rate for reading material or all medicines, small businesses selling these items would have to invest in sophisticated cash registers to distinguish between sales at different VAT rates. Larger businesses with sophisticated point-of-sale computer equipment should be able to process transactions at different rates without problems. But system changes would nevertheless have to be made, resulting in additional once-off cost.

## Neutrality

### Concessions in general

If any form of concession is allowed to certain categories of books or other reading material, or for medicines, or if a concession is dependent upon the person selling the product or the place of consumption or use, preferences and choices of consumers and suppliers will be distorted, thus affecting neutrality in the market.

Another difficulty of exemptions and zero-ratings is that the more concessions are granted, the more interest groups and industries would want to claim concessions for their products and industries, which will merely result in the further erosion of the tax base.

### Zero-rating

From a VAT purist perspective, zero-rating should be applied only for the benefit of the final consumer. Therefore, if goods or services are of such a meritorious nature that consumers should not have to pay VAT thereon, only the final consumer in need of the concession should be charged VAT at nil per cent.

A zero-rating often creates a lost cash-flow benefit for the vendor or creates a cash-flow problem. The vendor will no longer charge VAT to his customers which he can effectively use to fund the VAT payable by him. In industry sectors where small profit margins apply, this can result in real cash-flow implications for vendors, with accompanying pleas for the zero-rating of their inputs. Adherence to such requests will necessarily move the cash-flow problems up higher in the production or distribution chain, with more and more vendors ultimately requesting zero-rating of their input costs.

Introducing a zero-rating during the existence of the VAT system will result in benefits for certain vendors or sectors of the economy. Where a standard rating is transformed to zero-rating, vendors will no longer have to charge VAT, resulting in their prices being lower while they can still claim all their VAT inputs. Where an exemption is transformed to a zero-rating, vendors will be entitled to deduct the VAT incurred by them as input tax and will not have to charge VAT. Unless the cost saving is passed on to the consumer, the transition from an exemption to a zero-rating will merely result in further distortions.

## Exemptions

Due to the fact that VAT incurred on the acquisition of goods or services for purposes of consumption, use or supply in the course of making exempt supplies cannot be deducted as input tax, an exemption results in hidden or trapped VAT cost. Therefore, while consumers may be under the impression that a VAT benefit is enjoyed due to a concession by Government to exempt a supply with the result that no VAT is charged to the consumer, the VAT cost incurred by the vendor is passed on to the consumer by way of increased prices.

The amount of trapped VAT cost in the price of exempt goods or services will depend on the pricing structure of the vendor. The higher the labour and/or profit component of the price of the goods or services, the less trapped VAT cost will form part of the vendor’s selling price. On the other hand, where a vendor makes large capital investments or incurs high overhead costs, more VAT will be incurred which will be passed on to the consumer in his selling price.

Where the exempt goods or services are supplied to a final consumer, VAT will be trapped in only one stage of the distribution chain. If, on the other hand, the exempt supply is made to another vendor, the cost of the supply, including the trapped VAT cost, will be recovered in the ultimate selling price or service fee by the second vendor. If that vendor must charge VAT on his selling prices of goods or services, he will charge VAT on a trapped VAT cost. This undesirable phenomenon, known as tax-on-tax cascading of VAT, is regarded as one of the main disadvantages of sales tax. In fact, the removal of sales tax’s cascading effect is usually advocated as one of the main benefits of implementing a VAT system. The more exempt goods and vendors there are in the economy, the more probable it is that value added is taxed more than once, at different and unknown effective rates.[110]

[110] Tait *Broad-based tax op* cit 50.

## Conclusion

VAT concessions will normally reduce regressivity of the VAT system, if the expenditure patterns of the poor are viewed in isolation. In this regard, a zero-rating would normally be the most effective form of concession. The relative effectiveness of an exemption or lower VAT rate would depend on the pricing structure and ratio of investment/overheads to labour.

VAT concessions which cannot be targeted to apply only to the poor and needy, will distort equity in the economy, as the affluent will also benefit therefrom, thus worsening the regressivity of the VAT system. This will also affect the total revenue collected under the VAT, which might ultimately result in an increase in the VAT rate.

Any VAT concessions providing some form of relief to the poor will, unfortunately, affect other policy considerations of neutrality, efficiency and simplicity, as the tax system will become more complicated to operate for vendors and to control for the Revenue Authority of a country. A concession will normally distort consumer and producer choices and preferences, and will often result in further requests for concessions, on the assumption that the concession would level the playing fields which have been distorted by the previous concession.

# Chapter 8: Administrative impact assessment

## Introduction

A proposal to introduce relief for certain merit goods or services would undoubtedly be welcomed by consumers, the stakeholders who have requested the introduction of these concessions, as well as many businesses. However, Government has to rely on VAT registered vendors to effectively act as its VAT collection agents. Should the relief allowed result in additional and costly administrative and compliance burden for vendors, (coupled with the risk of penalties and interest in the event of the incorrect application of concessions), resistance to the proposed concessions might be experienced.

Should the application of the concessions by vendors create the opportunity for manipulation, a real risk of VAT evasion and even VAT fraud will arise. This would inevitably increase the cost of administration by SARS, as additional resources would be required to enforce compliance by way of increased auditing. The mere risk of increased avoidance and/or evasion or fraud could, in practice, place all vendors under suspicion resulting in increased anti-evasion and anti-fraud measures unnecessarily being imposed on all businesses.

Any investigation into the appropriateness of existing VAT concessions for merit goods or services, or the introduction of further VAT concessions to allow relief for merit goods or services should therefore include a consideration of the expected administrative impact thereof. The last question that this study seeks to investigate is, accordingly, whether changes in administrative and other systems technologies have advanced to an extent that the compliance cost constraint, that might previously have mitigated against the different treatment of certain goods or services, no longer poses a threat to a policy decision to allow VAT concessions for merit goods or services.

The administrative impact assessment of concessionary treatment for merit goods or services is conducted in this chapter by way of an analysis of –

- the policy considerations regarding the administrative impact of VAT concessions;
- the current administrative impact of existing and the anticipated impact of proposed concessions; and
- the effect which technological developments might have on such administrative impact.

# Administrative policy considerations

## Policy considerations at the introduction of VAT

When the Draft VAT Bill was published in 1990 and interested parties were invited to submit comments and representations to VATCOM, one of the objections to the proposed introduction of VAT was that VAT is a system which will be too complex to be administered by the less sophisticated businesses in South Africa. The response from VATCOM to this argument was that VAT had, at that stage, been introduced in some 50 countries worldwide, of which nearly half were in developing countries, of which five (5) were in Africa. On this basis, it was argued, there should be no reason why businesses in South Africa would not be able to similarly administer VAT. VATCOM further argued that, according to evidence at its disposal, the VAT system proposed in the Draft VAT Bill would be simpler to administer than those in operation in many other countries. It added that the proposed VAT system would be simpler to comply with than the prevailing GST system which had many exemptions and special rules.[111]

VATCOM pointed out that applying favourable treatment to any goods or services results in problems of definition and interpretation, creating opportunities for evasion and making monitoring and control of the VAT liability by businesses more difficult. It added that such concessions add significantly to the cost of administration and compliance, particularly for small businesses.[112]

VATCOM further argued that exemptions also increase the administrative and compliance burden, particularly where the exemption result in vendors making both taxable and exempt supplies, as inputs relating to taxable and exempt supplies have to be separately identified and mixed use inputs require apportionment calculations.[113]

While zero-rating would not result in the same apportionment difficulties, it was argued that it adds to the administrative costs as refunds have to be made by SARS to vendors, which requires monitoring ads concessions could create the opportunity for evasion.[114]

It was argued that the multiple rates, applied in various VAT systems, increase compliance costs significantly. VATCOM argued that the ad valorem excise duties, which have the effect of increasing the price of luxury goods and thus have the same effect as a higher VAT rate, would make the administration of the VAT system a great deal easier.[115]

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[111] VATCOM Report *op cit* 7 - 9.
[112] *Supra* 3 – 4.
[113] *Supra* 4.
[114] *Ibid.*
[115] *Ibid.*

VATCOM accordingly recommended that exemptions, zero-ratings and exceptions to the general rule should be kept to an absolute minimum to simplify the system and to minimise the opportunity for evasion. It added that every effort should be made to simplify the administration of the system to reduce the compliance costs to vendors, in particular, small vendors.[116]

## Investigations into tax reform

During 1994, the Katz Commission examined the perceived regressivity of the VAT system. Consideration was given to possible measures to shift the VAT burden onto higher income groups. The Katz Commission received several submissions arguing for a higher VAT rate on luxury goods or lower rates to help the poor, for example on medicine, health services and educational books.

While it was acknowledged that zero-rating or lower rates could decrease the VAT burden of lower income households and higher VAT rates on luxury goods could increase the VAT burden of higher income households, thereby decreasing the regressivity of the VAT system, it was noted that this could result in increased administrative and compliance burdens and increased scope for tax evasion.[117]

The Katz Commission concluded that adaptation to the VAT system was undesirable on revenue grounds, would have considerable administrative and compliance cost implications and could not be assured to provide relief in practice to the most vulnerable groups who most need support.[118]

## Amendments to accommodate small businesses

SARS announced in 1998 that it had been found that many small retailers selling both standard rated and zero-rated goods do not keep sufficient records to enable the Commissioner to verify the sales figures reported. The intention was to introduce a scheme for small retailers which would simplify their accounting requirements and reduce the amount of evasion.[119]

The Small Retailers VAT Package came into effect on 1 April 2005.[120] It allows SARS to grant a vendor permission to use this Package if the vendor supplies both standard rated and zero-rated goods from the same premises, his VAT-exclusive taxable supplies do not exceed R1 million per annum, he does not have adequate point-of-sale equipment and cannot account for VAT under the normal rules and the application of the Package will not materially distort his actual VAT liability.

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[116] *Supra* 10.
[117] Katz Interim Report *op cit* 119 – 121.
[118] *Supra* 127.
[119] Clause 38 of the Explanatory Memorandum on the Taxation Laws Amendment Bill 1998.
[120] Regulation 287 in Government Gazette 27425 of 1 April 2005.

The output tax payable for the tax period is the sum of all daily standard rated sales for the tax period multiplied by the tax fraction (14/114). The total of daily standard rated sales is calculated as the difference between the daily gross takings and daily zero-rated sales.

The benefit of the Package is that while the small retailer cannot accurately determine the output tax collected by him on his standard rated sales, he can account for an amount of output tax which is acceptable to SARS and will not result in penalties and interest.[121]

# The VAT compliance burden

## The global experience

A shift towards VAT concessions may trigger new compliance costs for businesses which should not be underrated as compliance costs includes not only human and information technology costs for producing VAT documentation, (e.g. billing, archiving, proof of exemption or zero-rating) but also the costs associated with preparing VAT accounts or reports and preparing and filing VAT returns. Unclear or outdated legislation and a lack of guidance from the tax authorities leads to uncertainty, thereby increasing compliance costs and risk. Errors regarding the application of VAT rules can trigger penalties and other costs for vendors. The Survey ("Paying Taxes") notes that an in-depth analysis of VAT compliance costs for companies would challenge the view that VAT is a neutral tax for businesses.

Experience has shown that burdensome taxes can be associated with a larger informal sector, as entrepreneurs often choose to avoid the formal system and operate underground. Simplifying the tax regime by reducing tax rates and eliminating exemptions can also reduce corruption in tax administration and improve efficiency. In addition, streamlined taxes also result in savings for government, as a complicated tax system has an associated cost of administration to monitor the tax.[122]

## The South African experience

The Katz Commission noted[123] that there is considerable evidence that the compliance burden of taxation falls disproportionately on smaller enterprises, who do not have expertise in the completion of tax returns and other aspects of tax compliance. It was stated that this problem had become more severe as a consequence of, inter alia, the introduction of VAT.

[121] However, to date only 41 vendors have registered in terms of the scheme.

[122] PricewaterhouseCoopers *Paying taxes op cit* 13 – 15.

[123] Katz Interim Report *op cit* 151.

Following a country-wide survey into the impact of VAT on South African business, PricewaterhouseCoopers issued its survey results named “The impact of VAT on South African business”[124] at the end of 2006. The survey results, which cover a wide range of commercial activities and industries, also address issues relating to VAT compliance cost.

Forty two per cent of respondents said that VAT was a substantial cost to their business, while 45% of these respondents confirmed that limited VAT cost was tracked.[125] Costs not tracked include costs in processing both the purchase and the sale of goods or services. While this impacts on processing time and system capacity, it is usually a hidden and unquantifiable cost.[126]

The PricewaterhouseCoopers VAT Survey also investigated whether specific changes have been made to businesses’ accounting systems to accommodate VAT.[127] Forty five percent of respondents said that they had made changes to their accounting systems to accommodate VAT, including –

- creating reports to calculate non-supplies;
- reporting systems to test compliance;
- warnings for the use of exempt codes; and
- creating VAT trails to support the VAT return and for monitoring compliance.

While it is evident that the VAT system imposes additional compliance costs for vendors, the results of the PricewaterhouseCoopers VAT Survey confirm that it is usually difficult to estimate the average cost of VAT compliance for the business sector, as the compliance cost differs depending on the size of a business (which would affect the number of VAT returns to be submitted per annum), whether a cash or invoice basis of accounting is applied, the VAT classification of a business’ transactions (i.e. taxable, exempt or mixed), as well as the nature of a business’ accounting system.

In fact, it is also difficult to accurately determine or even estimate the VAT compliance cost of a specific business. If a sophisticated accounting system is used, very little additional cost will have to be incurred to administer VAT, as the accounting system would already have been designed to cater for VAT administration. Similarly, to quantify the personnel cost of administering VAT would often be difficult. Where the personnel are in any case employed to perform general accounting and

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[124]This is hereinafter referred to as the “PricewaterhouseCoopers VAT Survey”. While 25 large businesses participated in the survey. While the survey was not conducted on a scientific basis aimed at obtaining accurate statistical information, it does provide useful and interesting information on the application of VAT by the business sector.
[125] PricewaterhouseCoopers VAT Survey *op cit* question 5.
[126] *Supra* 9.
[127] *Supra* question 10.

administrative functions, no additional cost has to be incurred to administer VAT. Salaries of employees are paid in any case, whether the personnel are busy with general accounting or related functions, or whether they are busy completing VAT returns or dealing with internal VAT queries.

Only where a VAT specialist, who is specifically responsible for VAT functions, is employed, or where the services of external consultants are acquired for purposes of a specific VAT project or problem, would businesses be able to identify and quantify their VAT compliance cost.

Despite these inherent limitations preventing an accurate estimate of VAT administration and compliance cost, the Consultancy has been requested by National Treasury to determine the current impact of concessionary treatment of merit goods or services as well as the anticipated impact which the introduction of concessionary treatment for the proposed merit goods or services would have.

## Views of Stakeholders

In the questionnaire,[128] which was distributed to the identified stakeholders, the stakeholders were requested to –

- Estimate the administrative and compliance costs associated with changing the VAT treatment of the proposed product,[129] and

- Provide any other information which could assist the Consultancy's task of conducting a cost/benefit analyses, including administrative compliance cost and economic inefficiencies caused by any reallocation of resources that could flow from tax changes.[130]

As outlined in the analyses of the responses by stakeholder, none of the submissions received were either willing or able to quantify the administrative and compliance cost associated with implementing a change to the current VAT treatment of a product. The Publishers' Association and the Pharmaceutical Society did, however, indicate that the administrative costs of a change in the VAT treatment of books and medicine would not be significant if these products were zero-rated.[131]

[128] The questionnaire which is reproduced in Chapter 4 above.
[129] Question 12 of the questionnaire.
[130] Question 13 of the questionnaire.
[131] Chapter 4 above.

# Administrative impact

Although no accurate data is available to quantify general VAT compliance costs, the administrative impact of the current VAT concessions as well as the proposed VAT concessions for merit goods on SARS and businesses are analysed below in the context of –

- Problems of definition, i.e. the problem to define the scope of the concession and to correctly implement and apply the concession;
- Requirements and procedures, i.e. the administrative impact of the introduction and application of rules for the concession;
- System changes, i.e. the need to the implement computer, bookkeeping and financial system changes; and
- Control and enforcement, i.e. the requirement to ensure the correct application of any concessions.

## Problems of definition

### *Impact on SARS*

The first problem resulting from a proposal to allow concessions, whether by way of exemptions, zero-ratings or lower VAT rates, for certain supplies is definition related. In order to meet the policy goal of certainty, the scope of any concession has to be precisely defined.

Global VAT experience has shown that, regardless of the effort which goes into defining the scope of a concession, borderline cases will subsequently result in uncertainties for both vendors and the Revenue Authority, as well as evasion opportunities for unscrupulous vendors.

*<u>Existing merit goods or services</u>*

Current uncertainties (although manageable) regarding the precise ambit of the zero-rating of basic foodstuffs and the exemption of transport and educational services emphasise the problems experienced by SARS in defining the scope of the concession.

As these concessions are by now a well-established part of our VAT system, the problem of defining the concessions is not so severe that the removal of the concessions is required. However, as uncertainties result in increased costs for vendors, a risk of ignorant non-compliance and opportunities for VAT fraud, any ambiguities in the legislation should be addressed by way of amendments to the VAT Act, Binding General Rulings or VAT Interpretation Notes.

*Proposed merit goods*

A new concession will require the drafting of special provisions to exclude the specific supply from the ambit of the normal charging provisions of the VAT Act. A thorough knowledge of the goods or services involved will be required to ensure that all possible variations are considered and the provision is drafted in line with the intended ambit of the concession.

To date such concessions have generally been in the form of a zero-rating or exemptions. Any additional zero-ratings or exemptions could be added to the existing list of zero-ratings contained in section 11 of the VAT Act or the existing list of exemptions contained in section 12 of the VAT Act.

Currently, the VAT Act does not formally provide for any lower VAT rates, (except the effective lower rate of VAT for residential accommodation provided on a commercial basis for longer than 28 days), other than the zero rate.[132] The financial effect would thus be the same whether a lower VAT rate is allowed for certain merit goods or services, or whether the value of the supply, on which the standard VAT rate is calculated, is merely reduced. However, a reduction of the valuation of a supply is a silent or hidden form of concession. The possibility remains that many consumers might not understand or know that the amount of VAT payable has in fact been reduced and vendors may be confused as to how to calculate the VAT payable to SARS. An announcement that VAT is levied on certain goods or services at a lower VAT rate as well as references to the lower VAT rate on tax invoices and advertising material, would be a much more visible form of VAT relief.

Should it be decided to allow additional concessions in the form of a lower VAT rate, some amendments would have to be made to the VAT Act. The charging section,[133] which provides for the levying of VAT at 14%, would have to be amended to either list specific supplies qualifying for lower VAT rates, or refer to a new section,[134] which would then contain a list of goods or services qualifying for a lower VAT rate. The existence of a separate section listing supplies taxed at a lower rate would be a more structured approach but might open the door for additional requests for goods or services to be taxed at lower rates, although it could be argued that the risk of further requests is in any event inherent to the introduction of VAT concessions. In addition, the definition of 'tax fraction'[135] would have to be amended, to ensure that the correct

[132]Section 10(10) of the VAT Act provides that the VAT-inclusive consideration for the supply is deemed to be 60% of the all-inclusive charge for the supply of accommodation. Special provision had to be made on the VAT 201 return form to accommodate such lower VAT rate supplies.
[133] Section 7(1) of the VAT Act.
[134] For example a new section 11A.
[135] In section 1 of the VAT Act.

amount of VAT is calculated on VAT-inclusive prices, both for output tax and input tax purposes.

If the local supply of a certain product qualifies for zero-rating, an exemption or a lower rate, similar relief would have to be allowed for the importation of the same product.

The amendments introducing any concessions should clearly state the effective date of the amendment to ensure that uncertainty does not exist as to which transactions may benefit from the concession. While the VAT Act does contain transitional measures which will apply where a lower or higher VAT rate becomes effective, or where VAT is no longer payable, these general rules might not cater for the unique circumstances in the relevant industry affected by the concession. Thus, the effective date and transitional measures should be part of the definition process.

Once the ambit of the concession has been defined, SARS will have to attend to queries from vendors and requests for rulings regarding the exact ambit of the concession or the application thereof in their specific circumstances, on a continuous basis. SARS will have to properly train its personnel to be able to deal with such queries and be able to provide guidance to vendors on a consistent basis.

In due course, SARS might have to consider amendments to the VAT Act in an attempt to clarify any ambiguities causing uncertainties regarding the ambit of the concession or to eliminate discrepancies. Amendments might also be required to prevent abuse or in response to a court judgment against SARS. Any such amendments might merely trigger the repetition of all the aforementioned problems.

It should be noted, however, that these problems of definition have already been addressed in various countries around the world, including other countries in Africa allowing special relief for the merit goods or services investigated in this study, namely medical services, medicines, books and reading matter. While the scope of the definitions may create difficulties in practice, the concessions are in place.

### *Impact on vendors*

Uncertainties regarding the ambit of a concession, created by vague concessionary provisions or definitions or even discrepancies in the legislation, result in increased compliance cost.

Vendors often experience problems of interpretation regarding the ambit of zero-ratings or exemptions, as borderline cases arise even if the utmost care was taken to anticipate all possible scenarios when a provision was drafted.

According to the European Commission empirical evidence indicates that compliance costs associated with lower VAT rates can be sizeable. Differences in VAT rates between similar products may in particular give rise to a substantial number of administrative and legal conflicts about the proper classification of specific goods. Swedish estimates indicate that such cases have very significant costs for the society.[136]

*<u>Existing merit goods or services</u>*

In the case of the zero-rated foodstuffs, uncertainties often arise as to whether a specific product falls within the list of zero-ratings or not. This has through the years resulted in various requests for rulings on the ambit of the zero-rating of the basic foodstuffs, for example relating to fruit, vegetables, vegetable oil, milk, leguminous plants and dried beans.

In the case of the exemption for educational services, it is often not clear whether a certain service involves the supply of education or research, or whether a specific supply is ‘necessary for and subordinate and incidental to’ the supply of educational services. In the case of transport services, uncertainty often exists regarding who must be the fare-paying person or whether an exempt transport services or a standard rated renting of a vehicle is involved. Where houses and other places of accommodation are let, it is very often uncertain where the line should be drawn between exempt or standard rated letting, due to ambiguities caused by the relevant provisions of the VAT Act.

While the practical difficulties experienced by vendors are normally not of such a serious nature that it would warrant the removal of the zero-rating or exemption, difficulties relating to the interpretation of the exact ambit of the concession does increase the compliance cost for vendors. Vendors often have to obtain specialist advice or rulings from SARS to ensure that they apply the zero-rating to the correct products. The issuing of Binding General Rulings to define the scope of concessions would assist vendors to correctly apply the provisions of the VAT Act, thus decreasing their compliance risks.

*<u>Proposed merit goods</u>*

If legislative amendments were to be introduced, vendors would have to train their personnel dealing with VAT issues to enable them to apply the correct VAT rate (e.g. standard rate, zero rate or a lower rate) or the exemption in the correct instances, and to ensure that the correct amount of VAT is claimed as input tax. Vendors might have to obtain specialist VAT advice to ascertain the VAT status of the supply or might have to request clarity from SARS by way of a ruling request. To enable vendors to train their personnel to correctly apply the new legislation, vendors would require sufficient time to implement the new concession.

[136] Study on reduced VAT applied to goods and services in the Member States of the European Union, European Commission, 21 June 2007 *op cit* 6. See http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm.

Should the supply of certain books and other reading matter, or the supply of medicines be provided relief by way of a zero-rating, exemption or lower rate, the correct VAT classification of the product by the manufacturer, importer or other first distributor would be essential, as subsequent wholesalers or retailers would merely apply the same VAT classification as applied when they purchased the product. In such a case, the impact of problems of definition for retailers, who are often smaller businesses and normally do not employ VAT specialists, would be negligible.

Vendors may have to make costly system changes to computer and accounting systems once the correct VAT treatment of a supply has been determined. By that time, a vendor may already have become liable for VAT which was incorrectly not charged and collected from customers. This might result in the assessment of outstanding VAT as well as penalty, interest and even additional tax.

As noted with regard to the impact on SARS, vendors in many countries in the rest of the world, as well as in Africa, have to apply exemptions, zero-ratings or lower VAT rates for medical services, medicines, books and other reading matter. Problems are bound to be experienced in these countries as well, but apparently not that insurmountable, otherwise the concessions would already have had to be removed.

## Requirements and procedures

### *Impact on SARS*

*Existing merit goods or services*

In an attempt to prevent or eliminate VAT avoidance and/or evasion or fraud relating to the existing zero-rating provisions, strict guidelines have in the past been issued by SARS, setting out the requirements which must be met for the zero-rating of the relevant transactions to be allowed by SARS.

The procedures and documentary requirements which must be met to substantiate the zero-rating of exports are set out in Interpretation Note 30, while the documentary requirements for other zero-rated supplies are set out in Interpretation Note 31. The difficulties experienced in issuing comprehensive guidelines, which are at the same time practical for businesses, are evident from the fact that the original version of Interpretation Note 30 (issued on 31 March 2005) had to be revised, resulting in the publication of Issue 2 thereof on 15 March 2006. To eliminate uncertainties, SARS is currently in the process of consolidating all documentary and other requirements relating to exports for purposes of the publication of a Regulation.

*Proposed merit goods*

Investigating the relevant transactions and laying down these documentary requirements have the effect that the administrative costs for SARS is increased.

Where SARS must lay down the procedural requirements as well as qualifying documentary proof, there is always a risk that inadequate or outdated knowledge of the relevant industry or distribution chain could result in shortcomings and omissions in the rules or requirements ultimately published, resulting in opportunities for avoidance and/or evasion.

Unrealistic or impractical requirements result in increased compliance cost and thus a multitude of requests from vendors for special dispensations in specific circumstances or industries, as well as negative publicity and lobbying for changes.

In addition to specific requirements and procedures which are generally addressed in special Interpretation Notes or Regulations, the VAT Guide for Vendors as well as other industry guides would have to be amended, should further VAT concessions be introduced.

### *Impact on vendors*

*Existing merit goods or services*

Too stringent, unrealistic or impractical requirements inevitably increase vendors' compliance costs. For example, in the case of the documentary proof required for zero-rating exports or services, certain requirements may be impractical to meet for individual businesses. Instead of changing their systems or procedures to obtain the required proof, many vendors might merely ignore cumbersome procedural requirements, without realising the risk of non-compliance. Vendors are at risk of incurring penalty, interest and even additional tax, should the zero rate be applied without the prescribed procedures having been followed or the substantiating documentary proof having been obtained.

*Proposed merit goods*

Additional requirements and procedures laid down to apply additional concessions result in increased compliance costs for vendors. Personnel must be trained to ensure that the required procedures and documentary requirements are met in each specific case.

## System changes

Any VAT amendments potentially require changes to computer, administrative and accounting systems to ensure compliance with amendments relating to the charging of VAT, deductions allowed to vendors or vendors' VAT obligations. Although the cost and related difficulties of such system changes are often substantial, the VAT amendments often do not provide special phasing-in relief for vendors. Transitional measures are normally introduced only where large policy changes are made, such as when the requirement that the recipient's VAT registration number must be included in tax invoices was introduced, or as in the case of the recent changes to the VAT dispensation for municipalities. It could thus be argued that the system changes which would be required due to the introduction of further concessions should not be insurmountable.

On the other hand, the perception exists globally that VAT concessions affecting the amount of VAT chargeable under certain circumstances would increase vendors' compliance costs due to system changes required to be made. In order to evaluate these claims, the anticipated impact on SARS and vendors is analysed below, in the context of the different possible forms of concessionary VAT treatment.

### *Zero-rating of merit goods or services*

#### *Impact on SARS*

Should it be decided to zero rate additional merit goods or services, SARS would have to reprogramme its computerised risk analysis and audit programmes (including data mining system), aimed at identifying VAT audit risks to accommodate any new zero-ratings, otherwise a sudden decrease in output tax accounted for by vendors who, as a result of the concession, suddenly make only or mainly zero-rated supplies, would incorrectly be identified as a compliance risk.

Similarly, the lack of output tax, against which input tax claims can be offset, might result in sudden increases in VAT refund claims. If system changes are not made to take this into account, unfamiliar VAT refund trends in certain industries will be confusing and could result in unnecessary queries. The additional VAT refunds would, in itself, increase pressure on the electronic VAT refund mechanism.

No changes would be required to the VAT return form itself, if concessions take the form of zero-ratings.

#### *Impact on vendors*

Should additional zero-ratings be introduced, vendors would have to implement changes to point-of-sale equipment to ensure that the supply of the relevant goods or services to recipients is made at the zero rate and that tax invoices issued to recipients adequately indicate that VAT has been charged at 0% on the supply.

Care would have to be taken that changes to the accounting system does not have the result that VAT incurred on inputs related to the zero-rated supply is blocked from being claimed as a credit. Accounting software packages would thus have to be programmed to take account of the zero-rating. Should an existing exemption be changed to a zero-rating (for example if the supply of educational services, which is currently exempt, were to be zero-rated), the computerised accounting system would have to be adjusted to ensure that VAT incurred on goods or services acquired to make the supply is no longer ignored for input tax purposes, but is claimed as input tax and that any qualifying change in use adjustments are identified and made in time.

A negative consequence of not levying VAT on zero-rated supplies would be that output tax would no longer be available for the financing of VAT incurred by the vendor. This could require changes to existing financial systems and arrangements. The exact impact of lost cash flow benefits would, of course, depend on factors such as the ratio of any new zero-ratings to standard rated supplies made by a vendor, as well as whether a certain product is zero-rated as such, or whether supplies made by a certain supplier are zero-rated.

Should the sale of books qualify for zero-rating, the vendor selling the books will forfeit the cash flow advantage of VAT collected on the books, but will also benefit from not having to pay VAT on the purchase of books from publishers. His cash flow position would thus be neutral. If he only makes zero-rated supplies, he would still be required to remain registered as a vendor and submit VAT returns. The same consequences would follow for a pharmacist, should the sale of medicines be zero-rated, although pharmacists normally also sell various other products, such as cosmetics and general health care products which would remain standard rated. The pharmacist would thus still be paying VAT to certain suppliers and collecting VAT from certain customers.

On the other hand, the zero-rating of the supply of medical services could have real cash flow implications for doctors and other health care practitioners. They would still have to pay VAT on their overheads and the rental or purchase of capital equipment and consumables, but would no longer be collecting substantial output tax which could be used to finance the VAT on acquisitions. These vendors would have to make adequate provision for such cash flow changes to their financial systems. The exact impact of this consequence would, of course, depend on the existing ratio of cash receipts to credit receipts. If the supplier is currently on the invoice basis but mainly supplies on credit, such as where a doctor submits claims to Medical Aid Schemes, he might be better off if he does no longer have to account for output tax of VAT not yet received.

Where a small business does not operate a computer system or does not have sophisticated point-of-sale equipment, it would have to change the prices of all newly zero-rated goods to ensure that VAT is charged at the correct rate. The VAT Act does provide that the Commissioner may allow vendors to display prices of goods or services other than in the form of the prescribed VAT-inclusive prices during an approved period, commencing before and ending after the date on which the VAT rate is increased or reduced.[137]

While the Small Retailers VAT Package, alleviates the compliance burden for small vendors, the Package still requires additional compliance efforts for businesses

[137] Paragraph (iii) of the proviso to section 65(1) of the VAT Act.

without computerised point-of-sale equipment and trained bookkeeping staff, compared to when supplies are merely subject to the standard rate of VAT.

### *Exemption of merit goods or services*

*Impact on SARS*

The introduction of further exemptions would place an additional burden on SARS as far as enforcement is concerned. SARS computerised risk analysis system, aimed at identifying VAT audit risks, would have to be re-programmed to take any new exemptions into account, otherwise a sudden decrease in output tax accounted for by affected vendors would incorrectly identify a non-compliance risk.

Control systems would also have to be able to identify vendors who would experience a reduction of input tax deductions, or who would have to account for output tax adjustments due to a change in the use of assets or stock, as the assets or stock will in future be applied for purposes of making exempt supplies. Where vendors would be making solely exempt supplies, for example if medical services and medicines were to be exempted, SARS would have to be able to identify the relevant service providers to ensure that their VAT registration is cancelled.

The introduction of further exemptions would, however, not require amendments to the VAT return form.

*Impact on vendors*

Vendors who will, as a result of the introduction of a new exemption of merit goods or services, be making exempt supplies will have to make considerable system changes. Existing software will have to be programmed to ensure that a 14% VAT charge is no longer included in the price of sales or services. Point-of-sale equipment will have to be programmed to ensure that VAT is not charged and that tax invoices are not issued for exempt supplies. Where a vendor makes both taxable and exempt supplies, tax invoices should clearly indicate which supplies are exempt supplies, to ensure that the recipient cannot claim VAT on exempt supplies made to him.

Further, system changes would have to be made to identify goods or services acquired to make the exempt supplies, to ensure that the VAT paid thereon is not deducted as input tax. Change in use output tax adjustments would also have to be made for goods or services applied wholly for exempt purposes, or where the taxable use of certain capital goods have decreased by more than 10%.

A supplier who will, as a result of most of his supplies becoming exempt from VAT, no longer be entitled to be registered as a VAT vendor, would have to apply for the cancellation of his registration and would have to account for output tax on all goods or services on the date of cancellation. This may result in considerable cash flow problems for a vendor.

If a supplier does not have to be deregistered as a VAT vendor, as he also makes other taxable supplies, the inevitable result will be that his accounting system would have to be able to distinguish between acquisitions for taxable supplies and exempt supplies. To the extent that acquisitions relate to both these supplies, such as in the case of overheads, the accounting system would have to be programmed to calculate the deductible VAT in accordance with the approved apportionment percentage. This percentage will have to be calculated on the basis of the turnover method, unless the vendor has obtained prior approval for another method from SARS.

To implement and test these system changes, vendors would require sufficient time from the date of publication of the amendment allowing the concession until the effective date of implementation of the amendment.

Where a vendor's taxable supplies are changed to exempt supplies, his pricing structure would have to be adjusted to remove the 14% VAT element, while taking into account of the VAT cost borne by the vendor on his inputs. However, there is no provision in the VAT Act which requires the vendor to reduce his prices to pass on the benefit of the exemption to his customers. Unless competition in the market forces a business to decrease prices, the business, rather than the end-consumer will benefit from the introduction of the exemption. In addition, if the vendor has to account for output tax on assets which will in future be used to make exempt supplies, he might not be in the financial position to pass on the full VAT benefit to end-consumers. The impact which the introduction of a further exemption would have on vendors' pricing systems would thus differ from business to business.

### ***Lower VAT rates***

*Impact on SARS*

The imposition of lower VAT rates would be new to the South African VAT system. The VAT return form would have to be amended by adding an additional line for supplies made at a lower rate, and additional notes to explain the lower rate would have to be included on the back of the VAT return form.

This would require changes to SARS computer systems as additional information on the VAT return form would have to be captured. SARS would have to change its risk analysis system for vendors making supplies at lower VAT rates, otherwise a sudden decrease in VAT accounted for, or an increase in the average number of refund claims made by the vendor, would result in unnecessary queries.

*Impact on vendors*

Vendors would have to adjust their point-of-sale equipment to ensure that the relevant supplies are made at the new lower VAT rate. Tax invoices would also have to reflect the rate at which each supply has been taxed, or should include the total amount of VAT charged for each line item. If merely the total amount of VAT charged on a list of standard rated supplies is stated at the end of a tax invoice containing various supplies, such as in the case of retail stores, without an indication of the rate of VAT, vendors capturing each line item separately into their accounting systems and applying the tax fraction to that amount to capture the VAT incurred on the supply, would eventually deduct too much VAT as input tax.

Vendors would also have to implement changes to their accounting systems, to allow for supplies and purchases to be reflected at a lower rate of VAT. As these system changes would normally require new programming of computer systems, in contrast to additional zero-ratings or exemptions which would merely require additional supplies being classified as zero-rated or exempt, vendors would require sufficient time to implement these new changes, to test the system changes and train staff.

Vendors who do not operate electronic point-of-sale equipment or computerised accounting systems would have to change their existing bookkeeping systems to ensure that tax invoices reflect supplies at the correct rate and that their VAT return forms can be completed correctly.

While the introduction of lower rates will result in only a limited number of vendors making supplies at lower rates, all vendors could, in principle, acquire a supply of goods or services which is subject to VAT at a lower rate. For example, should books or other reading matter be taxed at a lower VAT rate of 5%, all vendors purchasing any books or reading matter would have to adjust their accounting systems to ensure that the purchase will be captured at the correct VAT rate, otherwise the mere application of the tax fraction (based on the standard VAT rate) would result in an over-claim of VAT, eventually resulting in penalty or interest.

It is therefore clear that the introduction of lower VAT rates would require significant system changes and the longest phasing-in period.

## Control and enforcement

### *Impact on SARS*

#### *Existing merit goods or services*

In an attempt to prevent or eliminate VAT avoidance and/or evasion or fraud relating to the existing zero-rating provisions, strict guidelines have in the past been issued by SARS, setting out the requirements which must be met for the zero-rating of the relevant transactions to be allowed by SARS. These requirements have the effect of increasing administrative costs for SARS. SARS has to monitor and audit compliance with these requirements to ensure that vendors indeed qualify for the application of the relevant concession and to ensure that all vendors are treated in a just and equal manner. SARS has to administer, audit and effect the VAT refunds owing to vendors who mainly make zero-rated supplies. The correct application of the concession has to be monitored by way of visits to vendors and audits of these transactions. Assessments have to be issued where non-compliance has been identified, resulting in correspondence, meetings, the implementation of dispute resolution procedures and even court procedures.

*Proposed merit goods*

Should a lower VAT rate be introduced, the level of control and enforcement to ensure that the new rate is applied correctly by both suppliers and recipients, would probably be greater than in the case of further zero-ratings or exemptions. On the other hand, should it be decided to change existing exemptions into lower rates, the level of control required on the long run might decrease as vendors would in such a case be entitled to deduct VAT incurred by them as input tax. SARS would then no longer have to monitor the application of input tax apportionment methods by vendors.

***Impact on vendors***

*Existing merit goods or services*

The PricewaterhouseCoopers VAT Survey[138] indicates that 68% of the respondents perceived VAT risk to be significant. While 97% of the respondents have put internal controls in place, 34% of the respondents believe their controls to be inadequate. It has been noted in the PricewaterhouseCoopers VAT Survey that VAT is an unobtrusive tax and it seems as if management tends to under-estimate its impact. Thirty two per cent (32%) of respondents regard VAT risk as not significant in their business. A further aspect which has been noted during the analyses of the VAT Survey is that the lack of internal controls might tempt employees to commit VAT fraud.

*Proposed merit goods*

Vendors will have to implement adequate risk management procedures, as penalty, interest and even additional tax could be levied if VAT was not charged on a supply due to incorrect programming of computer systems, due to the prescribed procedures not having been followed or due to the documentary requirements not having been obtained.

Point-of-sale equipment and accounting systems will have to be adapted by the addition of control mechanisms to ensure compliance. As a result of increased auditing and monitoring of these transactions by SARS, vendors would have to incur costs and time to satisfy SARS that all requirements have in fact been met. Due to the existence of avoidance, evasion or fraud, vendors might, in general, be under

[138] PricewaterhouseCoopers VAT Survey *op cit* Question 10.

scrutiny, resulting in increased visits and monitoring by SARS, with the resultant increase in compliance costs.

## Administrative and technological developments since 1991

The overview of policy considerations, which have in the past influenced Government's decisions to limit concessions by way of zero-ratings, exemptions and multiple rates, has revealed that these decisions were motivated by the view that any concessionary treatment would increase the administrative and compliance cost for vendors and would open the door for VAT evasion and fraud, resulting in increased cost for SARS to enforce compliance.

The analyses of the administrative impact which could be expected if relief were to be allowed by way of additional concessions in the form of zero-rating or exemption of, or lower VAT rates for, medical services, medicines, books or other reading matter, has revealed that the administrative impact would, in most instances, be significant. However, the anticipated administrative and compliance cost needs to be evaluated in the context of modern advanced technology which is at the disposal of the business sector. The question therefore has to be considered whether the identified difficulties are in fact insurmountable and the administrative and compliance cost theory is still relevant today, in view of administrative and technological developments which have occurred since the introduction of VAT.

### Position in 1991

#### *Small businesses*

At the time when VAT was introduced, computerised bookkeeping systems and software packages as well as electronic point-of-sale equipment, were relatively freely available and at the disposal of small businesses in South Africa. Similarly, information technology ("IT") specialists were available in most major centres in South Africa to perform required system changes and software programming.

However, due to the relatively high cost of computers and software at that stage, many small businesses were not in a financial position to invest in such systems. Many of these businesses were thus forced to operate manual systems. Businesses which did have computer systems, did not always have the latest business or accounting software packages. Further, while IT specialists were available, the high fees charged by, or salaries which had to be paid to IT specialists, due to their relative scarcity at that stage, would often have been out of reach of smaller businesses. Further, credit facilities for acquiring such systems and services were also not as readily available for these categories of businesses, compared to the position today.

It is accordingly evident that the high cost of compliance which would have resulted from further concessionary treatment, would have had an adverse effect for small businesses when VAT was introduced, as well as at the time when the Katz Commission considered VAT reform to address the perceived regressivity of the VAT system during 1994.

### *Medium-sized businesses*

Computerised accounting and point-of-sale equipment were generally applied by medium-sized businesses at the time when VAT was introduced during 1991. These businesses often employed the services of IT specialists, whether in-house or on a subcontractor basis as and when required. However, the high cost of computer equipment and software, as well as IT support services, was also significant for most of these businesses.

While these businesses may generally have been in a better position to absorb administrative and compliance cost, investment in this field was normally considered carefully.

### *Large businesses*

As a general rule, large corporations had by 1991 implemented world-class computerised and point-of-sale equipment, which would have enabled the businesses to apply any VAT provisions. Most of these businesses either had in-house IT specialists, or contracted with IT specialist service providers for continuous or ad hoc support services.

While the cost of computer and software packages and point-of-sale equipment, as well as the cost of employing IT specialists were also significant for these businesses, the large businesses would have been in a better position to absorb these costs.

### *Inland Revenue*

In 1991, the VAT system was introduced and administered by Inland Revenue, a division of the Department of Finance.

Sufficient funds were allocated to Inland Revenue to contract with IT specialists to develop, test and implement a sophisticated VAT computer system. The experience of other countries in this regard was available to Inland Revenue and representatives of the IMF also provided advice and assistance regarding the implementation of adequate systems which would enable Inland Revenue to administer and control the VAT system. Large emphasis was placed on enforcement, by way of the development of a risk analysis system, which would identify changes in trends and thus point out audit risks.

However, despite all these precautions, Inland Revenue suffered huge losses when unscrupulous individuals designed fraudulent schemes aimed at obtaining large amounts of undue VAT refunds. The system was also unable to combat all forms of VAT export fraud. The introduction of any additional zero-ratings or exemptions, and especially further lower VAT rates, would thus have increased the enforcement burden on Inland Revenue.

## Developments since 1991

South African businesses have been involved with VAT administration and compliance for more than 16 years. In most instances, systems and procedural changes to cater for the levying of VAT are by now part of usual business procedures. The VAT compliance burden may have become negligible for some vendors making only standard rated supplies, while other vendors who also make zero-rated and exempt supplies may be more aware of the continuous burden of VAT compliance.

The question arises whether the developments in respect of technology since the introduction of VAT during 1991 have been sufficient to ensure an easy and smooth adaptation of vendors' systems, should concessions be introduced for merit goods or services.

It is common knowledge that the information technology industry has experienced unprecedented growth during the past decade. The increase in IT products and software has resulted in a much wider range of available products, allowing purchasers a wide choice at the various price levels. Competition in the market has not only resulted in more products, but has also lead to a reduction of the price of personal computers. The cost of importation of computers and related products into South Africa has also been reduced during recent years, due to the removal and/or reduction of import and excise duties. The cost of software packages has, however, increased through the years.

As information technology is offered as a high school subject, more and more learners leaving school, in all economic levels of society, have at least some basic knowledge of computers, different software packages and computer programmes, and even basic programming. The learners can implement computerised bookkeeping systems where they get involved in family businesses, are employed by other businesses, or set up their own businesses. Many of them decide on an IT career and obtain tertiary computer training. This has resulted in a substantially larger number of qualified IT specialists who can be employed by businesses. The stable inflow of these new specialists into the market has lead to the situation where the more inexperienced has to accept lower fees, to the benefit of small and medium businesses.

The introduction of e-filing of VAT returns and payments has placed South Africa in the forefront of technologically advanced societies. Despite the benefits of e-filing, only 58% of respondents to the PricewaterhouseCoopers VAT Survey indicated that they made use of e-filing at the time when the Survey was conducted. Some of the respondents not using the e-filing system acknowledged the need to implement the system.[139]

It can therefore be concluded that the modern computer technology has advanced to such an extent that sophisticated computer systems and business packages, which would be able to accommodate the introduction of further VAT concessions, are freely available. While IT specialists would require some time to effect the necessary system changes, it would not be an impossible task.

However, should concessions be introduced, SARS would be dependent on the cooperation of each vendor, which (effectively) acts as a collection agent, for the continued effective and smooth operation of the VAT system. It should thus be carefully considered whether the trend of advanced IT systems is in fact as general as is often believed.

### *Small businesses*

The retail trade of computer equipment and software has increased to such an extent that many middle-class households have a computer system and e-mail connection at home. Most home entrepreneurs will thus normally have access to computer systems. Similarly, most formal small businesses have computer equipment in order to improve bookkeeping and costing systems, aimed at optimising the profitability of the business.

As more and more people have become computer literate, many formal small businesses can either attend to their own IT problems, will have an employee with basic computer and IT knowledge, or may even have employed an IT specialist.

Scanner equipment is widely used by even small formal retailers. This ensures that vendors would not have to remark the price of all affected products when a change in the VAT status of products came into operation. The new price for the bar codes of the relevant products will merely be fixed on the computer system, and a single new price label for each product can be affixed to the shelve.

While the cost of IT investment and support services would always be relatively high for small businesses, the introduction of further concessionary treatment would often merely acquire one-off system adaptations and should not increase the current general IT cost of the business.

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[139] PricewaterhouseCoopers VAT Survey, *op cir* question 11.

On the other hand, while IT support services are more readily available than when VAT was introduced, it cannot merely be assumed that all vendors would be able to make the required adjustments to software programmes. Where small vendors have scanner equipment and computerised accounting systems but they do not have the in-house knowledge to effect the required adjustments, these businesses would have to pay IT specialists for implementing the VAT changes. In addition, it should always be borne in mind that any system changes can be effected only once the exact ambit of the concession is fully understood. This means that where in-house VAT specialists are not available (which would normally be the case for small businesses), the services of VAT specialists would have to be acquired before any system changes can be effected.

Most formal small businesses might have invested in computer technology and systems since the introduction of VAT. However, the vast speed at which technology advances might result in a computer system acquired a decade ago no longer being up to standard, as it may not be compatible with the latest modern business software packages. Unless these smaller businesses can obtain financing to acquire the latest computer systems, they will not be easily able to implement further zero-ratings or exemptions, and especially not additional lower rates.

As the cost of IT technology is a problem especially for smaller businesses, the impact of the VAT registration threshold should also be taken into account. Due to the effect of inflation on the registration threshold limit of R300,000, more and more small businesses have to be registered as vendors. While the original threshold limit of R150,000 was increased to R300,000 with effect from 24 November 1999, subsequent adjustments to counter the impact of inflation have not been made.

Therefore, unless the VAT registration threshold could be increased to eliminate smaller vendors from the VAT system and minimum requirements relating to computerised bookkeeping systems and electronic cash registers could be laid down for certain categories of vendors applying for voluntary registration, it appears that further VAT concessions would result in significant increases in administrative and compliance costs for small vendors in particular.

### *Medium businesses*

Medium-sized businesses can no longer be effectively managed and controlled without modern IT technology. Regardless of the cost thereof for businesses, they have to invest in such technology and the necessary updates, although budgetary constrains might prevent them from keeping up to date with the latest developments.

As a general rule, medium-sized businesses would normally be in a position to implement system changes to cater for the introduction of further concessionary VAT treatment, just as adjustments must from time to time in any case be made to implement VAT and other tax changes. The implementation of further lower rates would, however, result in additional programming costs, and would require sufficient time for testing and implementation of the system changes and training of personnel. As many of these businesses do not have in-house VAT specialists, they would also have to incur costs in respect of specialist VAT advice to ensure that the system changes are made in line with legal requirements.

### *Large businesses*

Large businesses have to allocate a large portion of their budgets to IT systems and support. They will normally update their systems in line with the latest technology and will have in-house IT support.

According to the PricewaterhouseCoopers VAT Survey,[140] while a wide range of accounting systems is used by the respondents to the survey, the most popular is SAP, followed by Oracle and JD Edwards.

Twenty six percent of respondents to the PricewaterhouseCoopers VAT Survey indicated that they have an in-house VAT specialist,[141] while 58% of respondents rated VAT training as very important, 37% as moderately important and 5% as not important.[142]

Therefore, while they often employ tax specialists, large businesses might also require VAT specialist advice if further concessions are introduced, especially if further lower VAT rates have to be implemented. Due to the ambit of large businesses, training of employees located in branches all over the country will have significant cost implications.

To ensure that system changes are implemented correctly by all branches as well as other group companies situated all over the country, large businesses may require even more time to implement and test changes than smaller businesses. Internal control mechanisms would also have to be built in to prevent negligent non-compliance or fraudulent conduct by employees.

### *SARS*

Since the establishment of SARS, as an organ of state within the public administration, but as an institution outside the public service[143] during 1997, more resources, both in the form of human capital and IT equipment, have been allocated to SARS. Today, SARS is at par with Revenue Authorities in the rest of the world.

SARS employs various specialists, including chartered accountants, MBA graduates, economists and legal professionals, and has access to tools, such as data mining

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[140] PricewaterhouseCoopers VAT Survey *op cit* question 7.
[141] *Supra* question 14.
[142] *Supra* question 17.
[143] Section 2 of the South African Revenue Service Act 34 of 1997.

and benchmarking software, to monitor and enforce tax compliance, particularly on the part of large corporations. It continuously invests in training to ensure that its computer system, administrative system and VAT enforcement system can optimise VAT compliance and collections.[144]

While sufficient time would be required to affect system changes and train personnel across the country, SARS's systems would be able to implement any additional concessions. Further, SARS would be in a position to acquire specialist IT support services, if required.

## Conclusions

The problems of defining the scope of further VAT concessions, drafting the amendments to the VAT Act and regulating the procedural and documentary requirements for applying a new zero-rating, exemption or lower VAT rate could be significant to SARS.

Vendors making supplies of goods or services which are the subject of the concessions would have to obtain VAT advice as to the exact scope of the concession and how the concession would affect their output tax liability and the amount of input tax deductible by them. Without clarity in this regard, vendors cannot proceed with system changes.

Modern IT developments have advanced to such an extent that any business which has invested in scanner equipment or other electronic point-of-sale equipment and computerised accounting systems would be able to implement the system changes required to comply with a new VAT concession. While such changes would inevitably require sufficient time to be implemented and would result in additional costs for vendors, the changes would have to be made only on a one-off basis. It is thus arguable that the impact of introducing further concessions would be less than it would have been when VAT was introduced in 1991.

However, despite the availability of world-class IT systems and IT support services in South Africa, it must be accepted that not all small businesses have access to these IT benefits. These businesses would not be in a position to implement system changes to apply new zero-ratings, exemptions or lower VAT rates. They would either have to incur significant costs to invest in modern computers and accounting software packages or, if they cannot obtain the required credit facilities, would have to change their manual bookkeeping systems to implement the concessions. This creates the inherent risk of non-compliance with the provisions of the VAT Act where mistakes are made due to negligence or ignorance, with the resultant risk of penalty and interest. On the other hand, such bookkeeping systems inherently cause a risk

[144] In general PricewaterhouseCoopers' "VAT fifteen years in South Africa", (2006), 3

for manipulation and, in the ultimate case, VAT evasion, thereby increasing enforcement responsibility of SARS.

Should it nevertheless be decided to introduce further concessions, it appears that it would be preferable that the relief be given in the form of a zero-rating, which would require minimum system changes for vendors. Due to the impact of VAT apportionment on vendors making both taxable and exempt supplies, any introduction of exemptions will necessarily increase compliance cost for vendors and thus cost of enforcement for SARS.

Concessionary VAT treatment in the form of lower VAT rates should not be impossible to implement in South Africa. If clear definitions, rules and procedures and sufficient phasing-in time are allowed, vendors requiring system changes to sophisticated computerised accounting systems would be capable of implementing the lower rates in their businesses, albeit at a cost. While the exact impact of lower VAT rates on a vendor would depend on the volume of transactions (if any) which will be affected by the lower rate for the vendor, it appears that vendors without sophisticated computer systems and software would not be able to correctly and cost-efficiently apply lower VAT rates. Unless businesses invest in the necessary technology, they will have to implement time-consuming manual point-of-sale systems and control mechanisms to ensure that the lower VAT rates are applied correctly.

# Chapter 9: Recommendations

## Ideal VAT system

In spite of the fairly widespread use of exceptions internationally, the results of this study tend to confirm the view of the IMF that a VAT system with the smallest possible number of exemptions, zero-ratings and lower rates is desirable. In this context, efficiency and simplicity considerations should dominate, and equity and other social objectives should be pursued through the expenditure side of fiscal policy.

## Addressing regressivity with exceptions

The perception that VAT is inherently regressive is one of the primary motives behind calls for concessionary treatment. While it is true that the VAT paid by lower income households may represent a higher proportion of their disposable income in a given period, this arises because higher income households tend to save greater portions of their income. However, these savings are used in subsequent periods (during retirement for example) to finance current expenditure – at which stage the expenditure will attract VAT. The proportion of disposable income paid in VAT by different income groups over their respective lifetimes will therefore tend to converge and will probably not be markedly different.

In this context, there is substantial empirical evidence to indicate that existing zero-ratings and exemptions do little to reduce the perceived regressivity of the VAT system. In fact, in almost all cases, they serve to make the system more regressive by conferring substantially more benefits on higher income groups than on lower income groups. Unless ways can be found to target exceptions so that they are enjoyed only, or at least predominantly, by low income households, then the adoption or perpetuation of a favourable VAT dispensation should not be used as an instrument to counter regressivity.

## Existing zero-ratings

A strong economic case can be made for the removal of existing zero-ratings on all products (other than exports) with the possible exception of maize meal and mealie rice. However, the potential political backlash against such a step should not be underestimated. For these reasons any attempt to remove existing zero-ratings should be directly, and explicitly, linked with the adoption of direct fiscal measures to offset the impact of increased VAT charges on lower income households.

Two approaches could be considered. Either sub-categories of currently zero-rated products could be standard rated in a phased manner, with offsetting explicitly-linked increases in social pensions and other transfer payments (including the possible introduction of food stamps). The phasing could begin with product categories where the relative benefit enjoyed by higher income groups is the greatest – such as cooking oils with a gradually move to products where the relative benefits of zero-rating are more equally shared between higher and lower income households. The potential problem with this approach is that it would take a long time to implement, and the current means available to the authorities of reaching all low income households are quite limited.

Secondly, a “big bang” approach could be followed where all existing zero-ratings are scrapped (with the possible exception of maize meal and mealie rice) and simultaneously, a mechanism to channel income to all lower income households, such as significantly enhanced social grants, was introduced. This system of social grants or food support would, necessarily, need to have a broader reach than the existing social grant system – so that tangible and effective assistance was provided to all low income households. Such an approach would be easier to sell politically, and the trade-offs would be easier to calculate. It would, however, be imperative that the two initiatives were well synchronised and that the systems needed to administer such transfers were in place.

## Existing exemptions

Exemptions currently confer limited benefits and impose measurably larger compliance costs on the affected vendors – particularly where such vendors are engaged in mixed supply. They also tend to increase the regressivity of the VAT system because the bulk of benefits flow to higher income households. Consistent with the proposal to eliminate existing zero-ratings outlined above, exemptions should also be withdrawn except in cases where the goods or services are “hard-to-tax” – such as financial services and commuter transport by taxis.

Failing this, consideration should be given to replacing current exemptions with a lower rate of VAT – which should be set at a level that ensures that vendors are not subsidised, but will succeed in eliminating VAT from input costs. In the case of the products studied, this would require the products to be levied with VAT of between 7% and 8% at the final point-of-sale, while at the same time allowing vendors to claim back input credits. Such a system is predicated on the assumption that roughly half of the total value added of these products occurs at the final stage of the supply chain. It would have the advantage of substantially simplifying administration as it would remove the need to apportion costs between standard rated and exempt supplies.

## Proposed additional merit goods and services

Although there are international precedents for affording all of the proposed additional merit goods and services a preferential VAT dispensation, such an approach is not supported.

Apart from the fact that the adoption of a favourable VAT dispensation in the case of proposed merit goods and services would be inconsistent with the broad approach outlined above, the specific products considered would not, by virtue of a different VAT treatment, assist in reducing regressivity. Nor is it likely, in the case of books, that consumers would enjoy a substantial reduction in prices as a result of the product's zero-rating. In any case, we are persuaded by the view that the problem of relatively low book penetration in South Africa has its origins primarily in low levels of literacy and generally poor reading skills. This problem would be more effectively addressed by the provision of a variety of reading books in all official languages to all levels of primary and secondary schools in South Africa with priority being given to the first three years of formal schooling (grades 1 to 3). This will require substantial additional funding for the education sector, but would also provide significant benefits to the local printing and publishing industry.

The analysis of both prescription and non-prescription medicines indicates that the VAT incidence is currently shared between the supply chain and consumers in the ratio of 60% to 40%. This implies that consumers are likely to enjoy 40% or less of any "savings" facilitated by the adoption of a more favourable VAT dispensation. One of the problems with the market for medicines appears to be that there is limited and a-typical sensitivity by consumers to pricing in both the public and the private health care systems. This results in consumers either being indifferent to the price of medicines (in the public healthcare system), or actively favouring higher-priced medicines as a means of obtaining better "value for money" from medical schemes. Incentive structures for medical practitioners may serve to exacerbate the problem.

While acknowledging that the market for medicines is complex and deserving of additional study, the research team does not believe that these complexities strengthen the argument for a different VAT treatment to the status quo.

# Annexures

# Annexure 1

## Changing the tax mix – the European Union

In the short term, the higher savings induced by a shift towards indirect taxes may, of course, have the opposite effect through a reduction in the marginal propensity to consume, but empirical research by the EU QUEST model suggests that the long term growth effects are quite strong.

In attempting to find solutions for the sub-optimal economic growth performance of the European Union (EU) member states since 1990 (in comparison to both the United States of America and the average for emerging market economies), the Parliament of the EU has commissioned substantial research into the design of growth-enhancing policies.

One such study is related to an investigation of the likely effect on GDP of changes to the tax mixture, i.e. the relationship between direct and indirect taxes. According to the EU research (2005)[145], a cut of one percent of GDP in income taxes, combined with an equivalent increase in consumption taxes, would generate additional output of more than one percent.

Roeger & De Fiore[146] developed an endogenous growth model with firms exhibiting external or internal increasing returns. Firms are either perfectly or monopolistically competitive. Analysing the effects on economic efficiency of different fiscal regimes, the theoretical results of their model indicate that distortionary taxes have strong negative effects on growth and employment and they tend to increase with the degree of private returns.

Tax distortion occurs with income taxes and also in the event of a relatively large degree of differentiation in consumption taxes.

## Changing the tax mix – the OECD

In a recent discussion paper prepared by the OECD for the Working Party on Tax Policy Analysis and Tax Statistics, the efficiency effect of a change in the mixture between direct and indirect taxes is discussed. Due to the relatively more neutral economic impact of a broad-based consumption tax, it is generally claimed that indirect taxes have a smaller distortionary cost than direct taxes. Empirical evidence

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[145] European Union, 2005: Options for the fiscal policy design required for the financing of the European Social Model – the Verhofstadt tax policy proposal (unpublished reflection note)
[146] Roeger & De Fiore *"Growth and employment effects of fiscal regimes" in* Oxford Economic papers, Vol 51:1.

by Kneller, Bleany and Gemmet (1999)[147] suggests that direct taxes reduce the rate of economic growth whilst indirect taxes do not.

As emphasized by the EU QUEST model, the defining difference between direct and indirect taxes lies in the differential treatment of savings. Although a number of personal income tax systems exist that allow for preferential treatment of savings (e.g. tax exemptions up to a specified ceiling or relatively low capital gains tax rates), the OECD states that, as a general rule, direct taxes exert a stronger negative effect on savings propensities than indirect taxes[148].

The nature of progression of PIT plays a crucial role in understanding the efficiency gains to be derived from a shift in the mix to indirect taxes. The overwhelming majority of formal sector workers are faced with a marginal tax rate that is considerably higher than the average tax rate. This difference does not exist in the case of a broad-based consumption tax, except for a small minority of wealthy individuals who can afford to save substantially more than they consume.

A revenue-neutral change in the composition of taxes that lowers the PIT rate and increases the VAT rate can be engineered in such a way that it does not materially alter the tax burdens of the majority of workers.

Due to the existence of progression in PIT, however, such a shift will reduce the overall marginal tax rate (direct plus indirect). It follows that productivity will be enhanced and, as an inference, economic efficiency. The tax structure in South Africa.
A concise, statistical analysis of national government revenue trends is provided by Tables 1 and 2.

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[147] Kneller, R, Bleaney, M F, and Gemmell, N, 1999: *Fiscal policy and growth: evidence from OECD countries* in Journal of Public Economics, Vol 74:2.
[148] Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, 2006: The balance between direct and indirect taxes (Unpublished note by the Secretariat prepared for the Working Party no 2 on Tax Policy Analysis and Tax Statistics).

**Table 1: Government revenue trends 1990 – 2000 (Nominal)**

| Government revenue trends 1990 – 2000 (Nominal) | | | | | |
|---|---|---|---|---|---|
| **Source of tax** | **1990 R billion** | **% of Total** | **2000 R billion** | **% of total** | **Average annual growth** |
| Individuals | 20 | 25.3% | 85.9 | 42.8% | 15.7% |
| Companies – total | 14.4 | 18.2% | 30.2 | 15.1% | 7.7% |
| Companies – basic | 13.8 | 17.4% | 21 | 10.5% | 4.3% |
| STC | 0 | n/a | 3.1 | 1.5% | n/a |
| Pension funds | 0 | n/a | 5.3 | 2.6% | n/a |
| Other | 0.6 | 0.8% | 0.8 | 0.4% | 2.9% |
| Property | 1 | 1.3% | 3.8 | 1.9% | 14.3% |
| VAT | 16.8 | 21.2% | 48.4 | 24.1% | 11.2% |
| Excise duties | 2.9 | 3.7% | 9.5 | 4.7% | 12.6% |
| Fuel levy | 4.1 | 5.2% | 14.3 | 7.1% | 13.3% |
| Customs duties | 4.9 | 6.2% | 6.8 | 3.4% | 3.3% |
| Stamp duties | 0.7 | 0.9% | 1.6 | 0.8% | 8.6% |
| **Total** | **79.2** | **100.0%** | **200.5** | **100.0%** | **9.7%** |

*Source: National Treasury*

Two distinct phases of the composition of government revenue can be distinguished over this period, namely the period between 1990 and 2000 and the one between 2000 and 2006 (periods refer to fiscal years ended on 31 March of the particular year).

Trends in revenue growth for the six key sources of government revenue were distinctly different for these two periods, with each one of the six sources portraying a mirror-like image between the two time-frames. Each of the two phases will be separately discussed.

<u>Phase 1: Emphasis on personal income tax</u>

In the decade between 1990 and 2000, the contribution to total fiscal revenue by individual taxpayers increased quite sharply from 31% to 43%. This represents an increase of more than 38% in the share of the personal income tax (PIT), which has traditionally been the single most important source of fiscal revenue.

In sharp contrast, the share of company tax declined by more than 32% (from 22% of the total to only 15%) during this period. One obvious reason for this trend is the fact that much uncertainty prevailed over the future socio-economic dispensation in South Africa during most of the 1990s, which heralded the country's first democratic elections amidst fears in the business community over possible redistribution policies.

In addition, the latter part of the decade was characterised by global financial instability in several emerging market economies, which resulted in relatively strict monetary policy in South Africa. The decision of the Reserve Bank, late in 1998, to increase money market rates to approximately 25%, was widely regarded as an overreaction to temporary and short term currency weakness, and resulted in a sharp increase in bankruptcies of companies and close corporations, particularly small and medium-sized businesses. Although the country managed to escape an economic recession, the business cycle went into a downward phase for several months.

Lower company profits ensued with predictable negative implications for company taxation flows.

The decade between 1990 and 2000 also witnessed a marginal decline in the contribution of VAT to total taxation revenue, namely from 26% to 24%. This is partly explained by relatively subdued consumption expenditure by households over this period, as well as a deterioration of the efficiency of VAT collections. The latter trend is clear from the declining ratio of VAT to total household consumption expenditure, (HHCE) This ratio declined from 11% to 7.3% between 1990 and 1993. Although it improved again to 9.1% by 2000, it remained below the 1990 ratio.

A further characteristic of phase 1 is the fairly dramatic reduction in the contribution to fiscal revenue by import duties, named from 6.2% of the total to only 3.4%. This represents a decline of more than 55% and can be attributed to trade liberalisation as well as subdued levels of import growth during most of the 1990s. The shares of specific indirect local taxes (excise duties and the fuel levy) increased marginally from 3.7% to 4.7% and from 5.2% to 7.1%, respectively, over this period.

Phase 2: Shift to corporate taxation

Since 2000, a distinctly different trend emerged for all of the key sources of fiscal revenue.

**Table 2: Government revenue trends 2000 - 2006**

| Government revenue trends 2000 – 2006 | | | | | |
|---|---|---|---|---|---|
| **Source of tax** | **2000 R billion** | **% of total** | **2006 R billion** | **% of total** | **Average annual growth** |
| Individuals | 85.9 | 42.8% | 125.8 | 30.2% | 6.6% |
| Companies – total | 30.2 | 15.1% | 107.9 | 25.9% | 23.6% |
| Companies – basic | 21 | 10.5% | 84.9 | 20.4% | 26.2% |
| STC | 3.1 | 1.5% | 11.8 | 2.8% | 25.0% |
| Pension funds | 5.3 | 2.6% | 4.5 | 1.1% | -2.7% |
| Other | 0.8 | 0.4% | 1.7 | 0.4% | 13.4% |
| Property | 0 | n/a | 5 | 1.2% | n/a |
| VAT | 3.8 | 1.9% | 11.1 | 2.7% | 19.6% |
| Excise duties | 48.4 | 24.1% | 115 | 27.6% | 15.5% |
| Fuel levy | 9.5 | 4.7% | 15.8 | 3.8% | 8.8% |
| Customs duties | 14.3 | 7.1% | 20.7 | 5.0% | 6.4% |
| Stamp duties | 0 | n/a | 0.9 | 0.2% | n/a |
| **Total** | 6.8 | 3.4% | 19 | 4.6% | 18.7% |

*Source: National Treasury*

The most profound reversal of the trends that characterised the previous decade was for corporate taxation, which increased its contribution to total revenue by 72% (from 15% of the total to 22% of the total).

A note of concern needs to be raised with regard to this undue reliance on company tax as a principal generator of tax revenues, as company profits are substantially more volatile than the taxation bases of the other two key revenue sources (remuneration of employees and value added in the economy). In the event of future downward trends in commodity prices, a significant number of large local companies may be faced with diminished profits or even incur losses, which will jeopardize the comfortable fiscal position that has ensued in recent years and that has allowed government to end a two decade long position of being a net dissaver on its current expenditure budget.

A second striking feature of fiscal revenue trends since 2000 is the reversal of the reliance on personal income tax. Successive budgets have provided substantial taxation relief to low and middle income earners. As a result, individual taxation has declined by almost 30% (from 43% in 2000).

Thirdly, VAT has steadily increased its contribution to total fiscal revenue, namely from 24% in 2000 to almost 28% in 2006. In the process, VAT is on the verge of surpassing personal income tax as the single most important source of government revenue. One of the obvious reasons for the increased importance of VAT is the relative strong growth of value added in the economy over the past three fiscal years, with real GDP growth averaging almost 5% per annum.

A further reason is to be found in the enhanced efficiency of VAT collections, which has seen the VAT/ HHCE ratio increase from 9.1% in 2000 to a high of 11.6% in 2006.

## A comparison between SA and the OECD

In terms of the stated intention by the Minister of Finance to align tax dispensation of South Africa more closely with the systems of the country's major trading partners (Department of Finance: 2000)[149], it is useful to compare the tax mix between South Africa and the OECD countries. Such a comparison requires the exclusion of social security contributions by employees and employers, which are not yet present in South Africa.

It should be noted that this situation is destined to end, as the Minister of Finance recently announced the intention of the South African government to introduce a so-called second "pillar" of an unfolding social security system, namely a contributory savings and retirement scheme. The imminent introduction of a wage subsidy also

[149] Republic of South Africa, Department of Finance, 2000: Budget Speech by the Minister of Finance

came to the fore in the 2007 Budget, which is widely regarded as one of the most significant policy-orientated budgets in history.

It should also be noted that social security contributions in the OECD are well-established and represents 26% of total government revenue in 2005. This was larger than any of the other five principal sources of tax revenues (PIT, corporate income tax, general consumption tax, specific consumption tax and property tax).

Moreover, the share of social security contributions in the OECD has increased substantially between 1965 and 2005, namely from 18% to 26% of total fiscal revenue. Since 1975, a virtually corresponding decrease has occurred in the share of PIT in the OECD.

Tables 3 and 4 illustrate the composition of taxes in South Africa and the OECD, respectively, for two ten-year intervals (1985 to 1995 and 1995 to 2005). In the case of South Africa, the nominal values of the different sources of taxation are also provided. In order to facilitate ease of comparison, Table 5 depicts the tax structures of South Africa and the OECD for the ten-year interval between 1995 and 2005.

**Table 3: Tax structure in South Africa**

| Tax structure in South Africa | | | | | | |
|---|---|---|---|---|---|---|
| **Source of tax** | **1985 (Rm)** | **% of total** | **1995 (Rm)** | **% of total** | **2005 (Rm)** | **% of total** |
| Personal income tax | 9,078 | 30.6% | 51,179 | 39.7% | 125,645 | 28.4% |
| Corporate income tax | 8,243 | 27.8% | 16,930 | 13.1% | 103,221 | 23.3% |
| Payroll taxes | | 0.0% | | 0.0% | 4,872 | 1.1% |
| Property taxes | 1,064 | 3.6% | 8,935 | 6.9% | 36,294 | 8.2% |
| General consumption taxes | 8,157 | 27.5% | 32,768 | 25.4% | 114,351 | 25.9% |
| Specific consumption taxes | 2,843 | 9.6% | 18,195 | 14.1% | 55,210 | 12.5% |
| Other | 273 | 0.9% | 1,025 | 0.8% | 2,730 | 0.6% |
| **Total** | **29,658** | **100.0%** | **129,032** | **100.0%** | **442,323** | **100.0%** |

*Note: Data for fiscal years beginning 1 April*
*Sources: National Treasury (2001, 2006), SARB ( 2002;[150] 2006)*

[150] Data sourced from the Budget Reviews for the respective years and SA Reserve Bank Quarterly Bulletins for the last quarter of the respective years.

**Table 4: Tax structure in the OECD countries**

| Tax structure in the OECD countries | | | |
|---|---|---|---|
| **Source of tax** | **1985** | **1995** | **2005** |
| Personal income tax | 39.0% | 35.5% | 33.3% |
| Corporate income tax | 10.4% | 10.5% | 13.3% |
| Payroll taxes | 1.3% | 1.3% | 1.3% |
| Property taxes | 6.5% | 7.9% | 8.0% |
| General consumption taxes | 20.8% | 23.7% | 25.3% |
| Specific consumption taxes | 20.8% | 17.1% | 14.7% |
| Other | 1.3% | 3.9% | 4.0% |
| **Total** | **100.0%** | **100.0%** | **100.0%** |

*Note: Excludes social security contributions*
*Source: OECD*[151]

The following observations can be made:

- South Africa has followed the OECD trend with regard to lowering the tax contribution by individual taxpayers.

- A rising trend in the tax contribution by companies is evident in both regions, but is considerably more pronounced in South Africa. Since 1995, corporate taxation has steadily increased its relative weighting in South Africa's tax structure, and in the 2007 Budget, it is more or less on par with the other two major sources of taxation, namely PIT and VAT.

- The general consumption tax (which is essentially VAT, except for the US), in the OECD has steadily increased its share of total fiscal revenue, with a concomitant decrease in the share of specific consumption taxes. South Africa has not followed the trend, with the contribution of general consumption taxes having declined from 27.5% of the total in 1985 to 25.9% in 2005.

- South Africa has also followed the opposite trend to the OECD with regard to the contribution of specific consumption taxes. In the OECD, the contribution of the latter to total government revenues declined by more than 27% between 1985 and 2005, whilst it increased by more than 30% in South Africa during this decade. However, a decline from 14.1% to 12.5% occurred in South Africa during the decade between 1995 and 2005 and the 2005 figure is lower than the 14.7% contribution in the OECD.

[151] Mendoza, et al, *op cit* vol 66:1.

**Table 5: Tax structures in South Africa and the OECD countries**

| Tax structures in South Africa and the OECD countries – 1995 & 2005 (% of total) | | | | |
|---|---|---|---|---|
| **Source of Tax** | **1995** | | **2005** | |
| | **South Africa** | **OECD** | **South Africa** | **OECD** |
| Personal income tax | 39.7% | 35.5% | 28.4% | 33.3% |
| Corporate income tax | 13.1% | 10.5% | 23.3% | 13.3% |
| Payroll taxes | 0.0% | 1.3% | 1.1% | 1.3% |
| Property taxes | 6.9% | 7.9% | 8.2% | 8.0% |
| General consumption taxes | 25.4% | 23.7% | 25.9% | 25.3% |
| Specific consumption taxes | 14.1% | 17.1% | 12.5% | 14.7% |
| Other | 0.8% | 3.9% | 0.6% | 4.0% |
| **Total** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |

*Sources: National Treasury (2001, 2006); OECD (2006)*

- It is also apparent that South Africa has decided to place considerably more emphasis on wealth taxes, with property taxes accounting for 8.2% of total government tax revenues in 2005 (including local authorities). This represents an increase of more than 127% over the 1985 figure. During the decade between 1995 and 2005 the increase in the share of property tax was more muted, namely 18.8%. In contrast, property taxation became more important as a key source of fiscal revenue in the OECD between 1985 and 1995 (an increase in its share of revenue of more than 21%), but it has remained virtually stagnant ever since. Currently, property taxes contribute marginally more to tax revenues in South Africa than in the OECD.

# Annexure 2

## EU Directive: Exemptions in the public interest

“CHAPTER 2

**Exemptions for certain activities in the public interest**

*Article 132*

1. Member States shall exempt the following transactions:

(a) the supply by the public postal services of services other than passenger transport and telecommunications services, and the supply of goods incidental thereto;

*(b) hospital and medical care and closely related activities undertaken by bodies governed by public law or, under social conditions comparable to those applicable to bodies governed by public law, by hospitals, centres for medical treatment or diagnosis and other duly recognized establishments of a similar nature;*

*(c) the provision of medical care in the exercise of the medical and paramedical professions as defined by the Member State concerned;*

*(d) the supply of human organs, blood and milk;*

*(e) the supply of services by dental technicians in their professional capacity and the supply of dental prostheses supplied by dentists and dental technicians;*

(f) the supply of services by independent groups of persons, who are carrying on an activity which is exempt from VAT or in relation to which they are not taxable persons, for the purpose of rendering their members the services directly necessary for the exercise of that activity, where those groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to cause distortion of competition;

(g) the supply of services and of goods closely linked to welfare and social security work, including those supplied by old people's homes, by bodies governed by public law or by or by other bodies recognised by the Member State concerned as being devoted to social wellbeing other organizations recognized as charitable by the Member State concerned;

(h) the supply of services and of goods closely linked to the protection of children and young persons by bodies governed by public law or by other organisations recognised by the Member State concerned as being devoted to social wellbeing;

*(i) the provision of children's or young people's education, school or university education, vocational training or retraining, including the supply of services and of goods closely related thereto, provided by bodies governed by public law having such as their aim or by other organisations recognised by the Member State concerned as having similar objects;*

*(j)* *tuition given privately by teachers and covering school or university education;*

(k) the supply of staff by religious or philosophical institutions for the purpose of the activities referred to in points (b), (g), (h) and (i) and with a view to spiritual welfare;

(l) the supply of services, and the supply of goods closely linked thereto, to their members in their common interest in return for a subscription fixed in accordance with their rules by non-profit-making organisations with aims of a political, trade-union, religious, patriotic, philosophical, philanthropic or civic nature, provided that this exemption is not likely to cause distortion of competition;

(m) the supply of certain services closely linked to sport or physical education by non-profit-making organisations to persons taking part in sport or physical education;

(n) the supply of certain cultural services, and the supply of goods closely linked thereto, by bodies governed by public law or by other cultural bodies recognised by the Member State concerned;

(o) the supply of services and goods by organisations whose activities are exempt pursuant to points (b), (g), (h), (i), (l), (m) and (n) in connection with fund-raising events organised exclusively for their own benefit, provided that exemption is not likely to cause distortion of competition;

*(p)* *the supply of transport services for sick or injured persons in vehicles specially designed for the purpose, by duly authorised bodies;*

(q) the activities, other than those of a commercial nature, carried out by public radio and television bodies.

2. For the purposes of point (o) of paragraph 1, Member States may introduce any restrictions necessary, in particular as regards the number of events or the amount of receipts which give entitlement to exemption.

*Article 133*

Member States may make the granting to bodies other than those governed by public law of each exemption provided for in points (b), (g), (h), (i), (l), (m) and (n) of Article 132(1) subject in each individual case to one or more of the following conditions:

(a) the bodies in question must not systematically aim to make a profit, and any surpluses nevertheless arising must not be distributed, but must be assigned to the continuance or improvement of the services supplied;

(b) those bodies must be managed and administered on an essentially voluntary basis by persons who have no direct or indirect interest, either themselves or through intermediaries, in the results of the activities concerned;

(c) those bodies must charge prices which are approved by the public authorities or which do not exceed such approved prices or, in respect of those services not subject to approval, prices lower than those charged for similar services by commercial enterprises subject to VAT;

(d) the exemptions must not be likely to cause distortion of competition to the disadvantage of commercial enterprises subject to VAT.

Member States which, pursuant to Annex E of Directive 77/388/EEC, on 1 January 1989 applied VAT to the transactions referred to in Article 132(1)(m) and (n) may also apply the conditions provided for in point (d) of the first paragraph when the said supply of goods or services by bodies governed by public law is granted exemption.

*Article 134*

The supply of goods or services shall not be granted exemption, as provided for in points (b), (g), (h), (i), (l), (m) and (n) of Article 132(1), in the following cases:

(a) where the supply is not essential to the transactions exempted;

(b) where the basic purpose of the supply is to obtain additional income for the body in question through transactions which are in direct competition with those of commercial enterprises subject to VAT.'

Article 143 provides for the exemption on final importation of goods of which the supply by a taxable person would in all circumstances be exempted within the country.

Member States may also apply one or two reduced VAT rates.[152] The reduced rates may not be less than 5 per cent and each reduced rate must be so fixed that the amount of VAT resulting from its application is such that the VAT deductible can normally be deducted in full.[153]

These rates may be applied only to the supply of natural gas or electricity,[154] the importation of certain works of art,[155] as well as the list of supplies contained in Annexure III,[156] which provides as follows (supplies which are relevant to the present investigation in South Africa are printed in italics):

"ANNEX III

**LIST OF SUPPLIES OF GOODS AND SERVICES TO WHICH THE REDUCED RATES REFERRED TO IN ARTICLE 98 MAY BE APPLIED**

(1) *Foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for*

[152] Article 98 of Directive 2006/112/EC.
[153] Article 99 of Directive 2006/112/EC.
[154] Article 102 of Directive 2006/112/EC.
[155] Article 103 of Directive 2006/112/EC.
[156] Article 98 of Directive 2006/112/EC.

*use in the preparation of foodstuffs; products normally used to supplement foodstuffs or as a substitute for foodstuffs;*

*(2)* *supply of water;*

*(3)* *pharmaceutical products of a kind normally used for health care, prevention of illnesses and as treatment for medical and veterinary purposes, including products used for contraception and sanitary protection;*

*(4)* *medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and supply of children's car seats;*

(5) transport of passengers and their accompanying luggage;

(6) *supply, including on loan by libraries, of books (including brochures, leaflets and similar printed matter, children's picture, drawing or colouring books, music printed or in manuscript form, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or predominantly devoted to advertising;*

(7) admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities;

(8) reception of radio and television broadcasting services;

(9) supply of services by writers, composers and performing artists, or of the royalties due to them;

(10) provision, construction, renovation and alteration of housing, as part of a social policy;

(11) supply of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings;

(12) accommodation provided in hotels and similar establishments, including the provision of holiday accommodation and the letting of places on camping or caravan sites;

(13) admission to sporting events;

(14) use of sporting facilities;

(15) supply of goods and services by organisations recognised as being devoted to social wellbeing by Member States and engaged in welfare or social security work, in so far as those transactions are not exempt pursuant to Articles 132, 135 and 136;

(16) supply of services by undertakers and cremation services, and the supply of goods related thereto;

(17) *provision of medical and dental care and thermal treatment in so far as those services are not exempt pursuant to points (b) to (e) of Article 132(1);*

(18) *supply of services provided in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 13*."